538/990

Department of the Treasury
Internal Revenue Service
Catalog Number 15068G

Publication 538

Accounting Periods and Methods

For use in preparing

1990 Returns

Contents

Accounting Periods.....1
- Calendar Tax Year.....1
- Fiscal Tax Year.....1
- Short Tax Year.....2
- Change in Accounting Period.....2
- Partnerships, S Corporations, and Personal Service Corporations.....3
- Section 444 Election.....4
- Corporations.....5
- Excise Tax Periods.....6
- Employment Tax Periods.....6

Accounting Methods.....6
- Cash Method.....6
- Accrual Method.....7

Inventories.....10
- Cost Identification.....10
- Valuing Inventory.....10
- Uniform Capitalization Rules.....11

Change in Accounting Method.....14
Index.....16

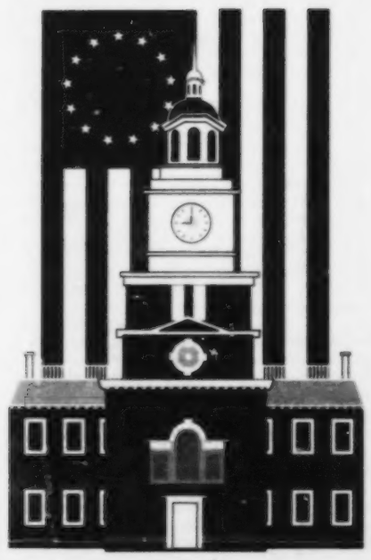
Introduction

This publication explains the rules for accounting periods and accounting methods. Every taxpayer (business or individual) must figure taxable income on the basis of an annual accounting period, called a tax year. Every taxpayer must also use a consistent accounting method. This is a set of rules used to determine when and how income and expenses are reported.

The most common accounting period is the calendar year. You may also use a fiscal year. Under certain conditions, a short tax year is permitted.

The two most commonly used accounting methods are the cash method and the accrual method. Under the cash method, income is reported in the tax year received, and expenses are deducted in the tax year in which paid. Generally, under the accrual method, income is reported in the tax year earned, regardless of when payment is received, and expenses are deducted in the tax year incurred, regardless of when payment is made.

Free publications and forms. If you need information on a subject not covered in this publication, you may check our other free publications. To order publications and forms, call our toll-free telephone number 1-800-TAX-FORM (829-3676) or write the IRS Forms Distribution Center for your area as shown in the income tax package.



Accounting Periods

Your taxable income must be figured on the basis of a tax year. The term "tax year" is the annual accounting period you use for keeping your records and reporting your income and expenses. The accounting periods you can use are:

- A calendar year, or
- A fiscal year.

You adopt a tax year when you file your first income tax return. You must adopt your first tax year by the due date (not including extensions) for filing a return for that year.

The due date for individuals and partnerships is the 15th day of the 4th month after the end of the tax year. Individuals include sole proprietors, partners, and S corporation shareholders. The due date for filing returns for corporations and S corporations is the 15th day of the 3rd month after the end of the tax year. If the 15th day of the month falls on a Saturday, Sunday, or legal holiday, the due date is the next day that is not a Saturday, Sunday, or legal holiday.

This section discusses: the calendar tax year; the fiscal tax year (including a period of 52 or 53 weeks); the short tax year; change in accounting periods; improper tax years; accounting period restrictions that apply to partnerships, S corporations, and personal service corporations; and special situations that apply to corporations.

Calendar Tax Year

If you adopt the calendar year for your annual accounting period, you must maintain your books and records and report your income and expenses for the period from January 1 through December 31 of each year.

If you filed your first return using the calendar tax year, and you later begin business as a sole proprietor, or become a partner in a partnership or a shareholder in an S corporation, you must continue to use the calendar tax year unless you get permission to change. See *Change in Accounting Periods*, later. You must report your income from all sources, including your sole proprietorship, salaries, partnership income, and dividends, using the same tax year.

You must adopt the calendar tax year if:

1) You do not keep adequate records,
2) You have no annual accounting period, or
3) Your present tax year does not qualify as a fiscal year.

Fiscal Tax Year

A regular fiscal tax year is 12 consecutive months ending on the last day of any month except December. A 52-53 week year is a fiscal tax year that varies from 52 to 53 weeks. See *52-53 Week Tax Year*, discussed next.

If you adopt a fiscal tax year, you must maintain your books and records and report your income and expenses using the same tax year.

52-53 Week Tax Year

You can use a 52-53 week tax year if you keep your books and records and report your income and expenses on that basis. This is a fiscal year that:

1) Varies from 52 to 53 weeks,
2) Always ends on the same day of the week, and
3) Always ends on:
   a) The date that day last falls in a particular calendar month, or
   b) The date that day falls nearest to the last day of a particular calendar month.

For example, if you elect a tax year that always ends on the last Monday in March, then for the tax year ending in 1991, your tax year will end on March 25, 1991. If you elected a tax year ending on the Monday nearest to the end of March, then for the tax year ending in 1991, your tax year will end on April 1, 1991.

Election. You make the election by filing your tax return for the 52-53 week year and attaching to it a statement showing:

1) The day of the week on which the tax year will always end,
2) Whether it will end on the last such day of the week in the calendar month or on the date such day of the week occurs nearest the end of the month, and
3) The month in which or with reference to which the tax year will end.

T22.44/2:

READEX FICHE best copy available

When you figure depreciation or amortization, a 52–53 week year is considered a year of 12 full months, unless you have consistently used some other practice in the past.

To find the due dates of returns or the effective dates of other provisions of the law that are expressed in terms of tax years beginning or ending with reference to the first or last day of a specified calendar month, a 52–53 week year is considered to begin on the first day of the calendar month nearest to the first day of the 52–53 week year. The 52–53 week year is considered to end on the last day of the calendar month ending nearest to the last day of the 52–53 week year.

Change to a 52–53 week tax year. You may change to a 52–53 week year that ends with reference to the end of the same month with which your present tax year ends, without first getting the permission of the IRS. You must attach the statement, discussed earlier under *Election*, to the tax return for the year for which the election is made.

Example. If you now use a calendar year and want to change to a 52–53 week year ending on the Friday closest to December 31, prior approval is not needed. You make the election to change by filing the statement with your return.

Approval required. If you change to a 52–53 week tax year that ends with reference to the end of a month that is not the same month in which your old tax year ended, you must first get approval from the IRS, as explained later in *Change in Accounting Period*.

For example, if you use a calendar year and want to change to a 52–53 week year ending on the Saturday nearest the end of November, you must first get approval from the IRS.

Change from a 52–53 week tax year. To change from a 52–53 week year to any other tax year, including another 52–53 week year, you must first get the approval of the IRS.

Short Tax Year

A short tax year is a tax year of less than 12 months. There are two situations that can result in a short tax year. The first occurs when you (as a taxable entity) are not in existence for an entire tax year. The second occurs when you change your accounting period. Each situation results in a different way of figuring tax for the short tax year.

Not in Existence Entire Year

A tax return is required for the short period during which you were in existence. Requirements for filing the return and figuring the tax are generally the same as if the return were for a full tax year of 12 months that ended on the last day of the short tax year.

Example 1. Corporation X came into existence on July 2, 1990. It elected the calendar year as its tax year. Corporation X must file its return by March 15, 1991. The return covers the period July 2, 1990, to December 31, 1990.

Example 2. A calendar year corporation dissolved on July 26, 1991. It must file its final return by October 15, 1991, for the period January 1 to July 26, 1991.

Example 3. Partnership YZ formed on September 5, 1990, and elected to use a fiscal year ending November 30. Partnership YZ is required to file its return by March 15, 1991.

Death of individual. When an individual dies, a tax return must be filed for the decedent by the 15th day of the 4th month after the close of the individual's regular tax year.

Example. Agnes Jones was a single, calendar year taxpayer. She died on March 6, 1990. Her last tax return for the period January 1 to March 6, 1990, must be filed by April 15, 1991.

Change in Accounting Period

You must, with certain exceptions, get approval from the IRS to change your tax year. To get this approval, you must file Form 1128, *Application to Adopt, Change or Retain a Tax Year*, and pay the correct user fee if any. This is explained later. This form must be filed by the 15th day of the 2nd calendar month after the close of the short tax year. This short tax year begins on the first day after the end of your present tax year and ends on the day before the first day of your new tax year.

Example. John Adams, a sole proprietor, filed his return using a calendar tax year. For business purposes, he wanted to change to a fiscal tax year ending June 30. John will have a short tax year for the period January 1 to June 30. Therefore, John must file Form 1128 by August 15. This is the 15th day of the 2nd calendar month after the close of the short tax year.

Extension. In some cases it may be possible to get an extension of time to change your tax year. See the later discussion, *Extension of time to file application*, under *Change in Accounting Method*. Your application must contain all of the information requested. Do not change your tax year until the IRS has approved your request.

If your application is approved, you must file an income tax return for the short tax year. There are special rules for figuring the tax for a short tax year caused by a change in your accounting period. See *Tax for short tax year*, later.

Net operating loss. If the short period required to effect the change is a tax year in which you have a net operating loss (NOL), you must deduct the NOL ratably over a 6-year period starting with the first tax year after the short period unless you meet one of the exceptions discussed later in item 4 of *Expeditious approval*, under *Corporations* (these exceptions are the same as the exceptions for other taxpayers).

Husband and wife. A husband and wife who have different tax years may not file a joint return. If the husband and wife want the same tax year so they can file a joint return, the method of changing a tax year depends on whether they are newly married.

Newlyweds. A newly married husband or wife may want to change his or her accounting period to that of the other spouse so they can file a joint tax return. The husband or wife can adopt the accounting period of the other spouse without first getting approval. They can file a joint return for the first tax year ending after the date of marriage if:

1) The due date for filing the required separate short tax year return of the spouse wishing to change (the 15th day of the 4th month following the end of the short tax year) falls on or after the date of the marriage, and
2) The return for the short tax year is timely filed.

If, on the date of the marriage, the due date for filing the required short-year return has passed, the couple cannot file a joint return until the second tax year ending after the date of the marriage, and then only if the spouse who is changing the tax year files a timely short tax year return. The short tax year must include a statement that the accounting period is being changed under authority of section 1.442-1(e) of the Income Tax Regulations.

Example. John and Jane were married on July 30, 1990. John filed his return for the fiscal year ending June 30. Jane used the calendar year, but wants to change to John's fiscal year so they may file a joint return. If Jane files a separate return by October 15, 1990, for the short period January 1 through June 30, 1990, she will have changed her accounting period to a fiscal year ending June 30. Then she and John can file a joint return for their tax year ending June 30, 1991.

Other spouses. Any other husband or wife wishing to change to the accounting period of the other spouse so that they can file a joint return must first get the permission of the IRS. Permission may be granted even if there is no substantial business purpose for requesting the change.

Tax for short tax year. If the IRS approves the change in your tax year, or you are required to change your tax year, you must figure the tax and file your return for the short tax year that begins with the first day after the end of your old tax year and ends on the day before the first day of your new tax year.

You figure the tax for your short tax year under a general rule. Then, after one year from the beginning of the short tax year, you can use a relief procedure under which you may be able to claim a refund of some of the tax you paid under the general rule. The general rule and the relief procedure are explained next.

General rule. Figure the income tax for the short tax year by placing your taxable income on an annual basis. Self-employment tax is figured on actual self-employment income and is not annualized.

Individuals. Individuals must figure their income tax for the short tax year under the general rule as follows:

1) Determine the adjusted gross income for the short tax year and subtract the actual amount of itemized deductions for the short tax year. You must itemize your deductions when you file a short tax year return.
2) Multiply the total amount of exemptions by a fraction. The numerator (top number) of the fraction is the number of months in the short tax year and the denominator (bottom number) is 12.
3) Subtract the amount in (2) from the amount in (1). This is your modified taxable income.
4) Multiply the modified taxable income (3) by 12 and divide by the number of months in the short tax year. This is your annualized income.
5) Figure the total tax on your annualized income using the Tax Rate Schedules.
6) Multiply the total tax by the number of months in the short tax year and divide by 12.

Example. Frank Jones has an adjusted gross income of $18,200. His itemized deductions total $4,200, and he can claim exemptions for himself, his wife, and two children. The income and the itemized deductions are for the 9-month period January 1 through September 30, 1990. He will figure his tax on a joint return for that period as follows:

1) $18,200 − $4,200 = $14,000
2) $2,050 × 4 × 9/12 = $6,150
3) $14,000 − $6,150 = $7,850 (modified taxable income)
4) $7,850 × 12/9 = $10,467 (annualized income)
5) Tax on $10,467 = $1,570 (from Tax Rate Schedule)
6) $1,570 × 9/12 = $1,178 (tax for short tax year)

Corporations. Corporations figure the tax for the short tax year under the general rule described above for individuals. There is no adjustment for personal exemptions.

Example. A corporation files a tax return, because of a change in its accounting period, for the 6-month short tax year ending June 30, 1990. It had taxable income of $40,000 during the short tax year. Its annualized taxable income is $80,000 ($40,000 × 12/6). Its total tax (as annualized) is $15,450. The tax for the short tax year is $7,725 ($15,450 × 6/12).

52–53 week year. If you must first get approval because you change the month with reference to which your tax year ends, you must file a return for the short tax year if it covers more than 6 but less than 359 days. Thus, if you use a calendar year and the IRS approves your election to change in 1991 to a 52–53 week year ending on the Monday closest to August 31, you must file a return for the short tax year from January 1, 1991, to September 2, 1991.

Figure the tax for the short tax year as shown previously, except that you annualize on a daily rather than a monthly basis. You use 365 instead of 12, and you use the number of days in the short tax year instead of the number of months. Use 365 days regardless of the number of days in the calendar year.

Relief procedure. You may use a relief procedure for figuring the tax for the short tax year. It may result in less tax. Under the relief procedure, the tax is figured by two methods. If both methods yield a tax amount that is less than the amount of tax that you figured for the short tax year under the general rule, you may file a claim for refund of some of the tax you paid under the general rule. Both individuals and corporations may use the relief procedure. For information on this relief procedure, see section 443(b)(2) of the Internal Revenue Code.

Alternative minimum tax for tax preferences. An alternative minimum tax imposed for the short tax year is figured by first annualizing the alternative minimum taxable income for the short tax year. Do this by multiplying that amount by 12 and dividing by the number of months in the short tax year. Then apply the appropriate rate of tax under section 55(a)(1) of the Internal Revenue Code to this annualized income to arrive at the annualized alternative minimum tax. This annualized tax is then prorated by multiplying the tax by the number of months in the short tax year and dividing that amount by 12. The result is the alternative minimum tax due for the short tax year.

For information on the alternative minimum tax for individuals, see Publication 909, *Alternative Minimum Tax for Individuals*. For information on the alternative minimum tax for corporations, see Publication 542, *Tax Information on Corporations*.

Tax withheld on wages. You can claim a credit against your tax liability for federal income taxes withheld from your wages. This withholding is always on a calendar year basis.

If you had more than one tax year begin in the same calendar year, the total amount withheld must be taken as a credit for the last tax year beginning in the calendar year.

Improper Tax Year

If you begin your business on a date other than the first day of a calendar month and end it exactly 12 months from the date it began and this ending date is other than the last day of the month, you have not satisfied the requirements for establishing a calendar year or a fiscal year. Nor does the adoption of an accounting period ending exactly 12 months from the date your business began satisfy the requirements for a 52–53 week tax year.

Because you have not satisfied the requirements for either a calendar or a fiscal year, you have adopted an improper tax year. You must either file an amended income tax return on the basis of a calendar year, or if you want to use a tax year other than the calendar year, you must get approval from the IRS to change your tax year. See *Change in Accounting Period*, earlier.

If you want to adopt a calendar year to correct an improper tax year, you must attach a completed Form 1128 to your amended income tax return that is filed on a calendar year basis. Put "FILED UNDER REV. PROC. 85–15," at the top of your Form 1128. The form and your amended return should be filed with the service center where you filed your original return.

User Fees

User fees are charged by the Internal Revenue Service for requests for changes in accounting periods and methods, and for certain tax rulings and determination letters. For more information and a schedule of fees for employee plans and exempt organizations, see Publication 1380, *User Fees*.

Do not send payment for the fee when filing Form 2553, *Election by a Small Business Corporation*. You will be notified when this fee is due. There is no fee for an information letter.

Category of request	Fee
Change in accounting period (Forms 1128 and 2553)	$200
Change in accounting method (Form 3115)	$500
Earnings and profits determinations (Form 5452)	NO FEE
Extension of time (Forms 1128, 2553, 3115, or 8716)	$500
All other rulings except employee plans and exempt organizations	$500 to $2,500

Partnerships, S Corporations, and Personal Service Corporations

Generally, partnerships, S corporations, and personal service corporations must use "required tax years." The required tax year does not have to be used if the partnership, S corporation, or personal service corporation establishes a business purpose for a different period (explained later), or makes a ***section 444 election*** (explained later).

Partnerships

A partnership is required to conform its tax year to its partners' tax years, unless the partnership can establish a business purpose for a different period or makes a section 444 election. The rules for the required tax year for partnerships are as follows:

1) If one or more partners owns an interest in partnership profits and capital of more than 50% (a majority interest), the partnership must adopt the tax year of those partners.
2) If there are no partners who own a majority interest or if the partners who do own a majority interest do not have the same tax year, the partnership is required to change to the tax year of its principal partners. A principal partner is one who has a 5% or more interest in the profits or capital of the partnership.
3) If no tax year is established by either the majority partners or the principal partners, the partnership must adopt a tax year that results in the least aggregate deferral of income to the partners.

Least aggregate deferral of income. The tax year that results in the least aggregate deferral of income is the tax year of one or more of the partners that results in the smallest deferral to all the partners. The deferral is the number of months from the end of the partnership's tax year to the end of each partner's tax year that ends on or after the date the partnership's tax year ends. Multiply the number of months by the partner's interest in partnership profits and add each partner's deferral to determine the total deferral. The partner's tax year that produces the smallest deferral is the partnership's tax year.

The determination of this tax year must generally be made at the beginning of the partnership's current tax year. However, the IRS may require the use of some other day or period that will more accurately reflect the ownership of the partnership.

More than one tax year. If more than one tax year qualifies, the partnership may select any one of those tax years as its tax year. However, if one of the qualifying tax years is also the partnership's existing tax year, the partnership must maintain its existing tax year.

Example. Partnership P is on a fiscal year ending June 30. Partner A reports income on the calendar year and Partner B reports income on the fiscal year ending November 30. A and B each have a 50% interest in P's profit. For P's tax year beginning July 1, 1989, P is required to change to a fiscal tax year ending November 30 because this results in the least aggregate deferral of income (B, .5 interest × 0 deferral = 0; A, .5 interest × 1 month deferral = .5). The calendar year would result in a much higher aggregate deferral (A, .5 interest × 0 deferral = 0; B, .5 interest × 11 month deferral = 5.5).

Change initiated by partnership. The change to this required tax year is treated as initiated by the partnership with approval from the IRS. The partnership must attach a statement showing the computations to the income tax return for the short period and must put at the top of page 1 of the return, "FILED UNDER SECTION 1.706–1T."

Information on partnerships. For general information on partnerships, see Publication 541, *Tax Information on Partnerships*.

S Corporations

A small business corporation can elect to be an S corporation. All S corporations, regardless of when they became S corporations, are required to use a calendar tax year or any other tax year for which the corporation establishes a business purpose for a different period, or makes a section 444 election, discussed later. For information on S corporations, see Publication 589, *Tax Information on S Corporations*.

Personal Service Corporations

Personal service corporations are required to use a calendar tax year unless they can establish a business purpose for a different period, or make a section 444 election, discussed later. For this purpose, a personal service corporation is a corporation in which the principal activity, during the testing period, is the performance of personal services that are substantially performed by employee-owners. Employee-owners must own more than 10% of the fair market value of the corporation's stock on the last day of the testing period.

Testing period. Generally, the testing period for a tax year is the prior tax year.

Example. Corporation A has been in existence since 1980. It has always used a January 31 fiscal year for its accounting period. To determine if A is a personal service corporation for its tax year beginning February 1, 1990, the testing period is A's tax year ending January 31, 1990.

New corporations. The testing period for a new corporation for its first tax year starts with the first day of the tax year and ends on the earlier of:

1) The last day of its tax year, or
2) The last day of the calendar year in which the tax year begins.

Example. B Corporation's first tax year begins June 1, 1990. B wants to use a September 30 fiscal year for its accounting period. B's testing period for its first tax year is June 1, 1990, through September 30, 1990. If B wants to use a March 31

fiscal year, the testing period is June 1, 1990, through December 31, 1990.

Performance of personal services. For this purpose, any activity that involves the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting is considered to be the performance of personal services.

Principal activity. The principal activity of a corporation is considered to be the performance of personal services if, during the testing period, the corporation's compensation costs for personal service activities is more than 50% of its total compensation costs.

Employee-owner. A person is an employee-owner of a corporation for a testing period if the person:

1) Is an employee of the corporation on any day of the testing period, and
2) Owns any outstanding stock of the corporation on any day of the testing period.

Independent contractor. For purposes of the employee-owner definition, a person who owns any outstanding stock of the corporation and who performs personal services for or on behalf of the corporation is treated as an employee of the corporation. This rule applies even if the legal form of the person's relationship to the corporation is such that the person would be considered an independent contractor for other purposes.

More information. For more information on the tax year of a personal service corporation, see section 1.441-4T of the Income Tax Regulations.

Section 444 Election

Partnerships, S corporations, and personal service corporations may elect to use a tax year that is different from the required tax year. Certain restrictions apply to this election, which is called a section 444 election. This election does not apply to any partnership, S corporation, or personal service corporation that establishes a business purpose for a different period, explained later.

A partnership, S corporation, or personal service corporation may make a section 444 election if:

1) It is not a member of a tiered structure (see section 1.444–2T of the Income Tax Regulations),
2) It has not previously had a section 444 election in effect, and
3) It elects a year that meets the deferral period requirement.

Deferral period. Generally, a partnership, S corporation, or personal service corporation may make a section 444 election only if the tax year elected results in a deferral period of 3 months or less.

An election to change a tax year will be allowed only if the deferral period of the elected tax year is not longer than the shorter of:

1) Three months, or
2) The deferral period of the tax year being changed.

For a partnership, S corporation, or personal service corporation that wants to ***adopt or change*** its tax year by making a section 444 election, the deferral period is the number of months between the end of the elected tax year and the close of the required tax year. If the current tax year is the required tax year, the deferral period is zero.

Example 1. BD Partnership uses a calendar tax year which is also its required tax year. Because BD's deferral period is zero, BD is not able to make a section 444 election.

Example 2. E, a newly formed partnership, began operations on December 1, 1990. E is owned by calendar year partners. E wants to make a section 444 election to adopt a September 30 tax year. E's deferral period for the tax year beginning December 1, 1990, is 3 months (September 30 to December 31, 1991).

Making the election. You make a section 444 election by filing Form 8716, *Election To Have a Tax Year Other Than a Required Tax Year,* with the Internal Revenue Service Center where you normally file your returns. Form 8716 must be filed by the earlier of:

1) The 15th day of the fifth month following the month that includes the day of the tax year for which the election will be effective, or
2) The due date (without regard to extensions) of the income tax return resulting from the section 444 election.

In addition, you must attach a copy of Form 8716 to your Form 1065 or appropriate Form 1120 for the first tax year for which the election is made.

In some cases, a late filing of Form 8716 may be accepted. However, applications received by the IRS 90 days after the due date will not be approved, except in very unusual and compelling circumstances.

Example 1. AB, a partnership, began operations on September 11, 1990, and is qualified to make a section 444 election to use a September 30 tax year for its tax year beginning September 11, 1990. AB must file Form 8716 by January 15, 1991, which is the due date of the partnership's tax return for the period September 11, 1990, to September 30, 1990.

Example 2. The facts are the same as in Example (1) except that AB began operations on October 20, 1990. AB must file Form 8716 by March 15, 1991, the 15th day of the fifth month following the month that includes the first day of the tax year for which the election will first be effective.

Example 3. B is a corporation that first becomes a personal service corporation for its tax year beginning September 1, 1990. B qualifies to make a section 444 election to use a September 30 tax year for its tax year beginning September 1, 1990. B must file Form 8716 by December 15, 1990, the due date of the income tax return for the short period September 1 to September 30, 1990.

Ending the election. The section 444 election remains in effect until it is terminated. The election ends when the partnership, S corporation, or personal service corporation:

1) Changes to its required tax year,
2) Liquidates,
3) Willfully fails to comply with the required payments or distributions, or
4) Becomes a member of a tiered structure.

The election will also end if an S corporation's S election is terminated, or a personal service corporation ceases to be a personal service corporation. However, if a personal service corporation that has a section 444 election in effect elects to be an S corporation, the S corporation may continue the election of the personal service corporation. Or, if an S corporation terminates its S election and immediately becomes a personal service corporation, the personal service corporation may continue the section 444 election of the S corporation.

If the election is terminated, another section 444 election cannot be made for any tax year.

Required payment for partnerships and S corporations. Partnerships and S corporations must make a "required payment" for any tax year that the section 444 election is in effect and the required payment amount is more than $500. You also must pay if you had a required payment for any prior tax year that was more than $500 and you have a liability of any amount for that applicable year.

Any tax year that a section 444 election is in effect, including the first year, is called an "applicable election year." This required payment represents the value of the tax deferral that the owners receive through the use of a tax year different from the required tax year.

Report the required payment on Form 8752, *Required Payment or Refund Under Section 7519.* If the required payment is more than $500 (or the required payment for any prior year was more than $500), pay it when Form 8752 is filed. If the required payment is $500 or less, and no payment was required in a prior year, no payment is required, but Form 8752 must be filed showing a zero amount.

When to file. Form 8752 must be filed and the required payment made (or zero amount reported) by May 15 of the calendar year following the calendar year in which the applicable election year begins. For example, if a partnership's applicable election year begins July 1, 1991, Form 8752 must be filed by May 15, 1991.

Personal service corporations. If a personal service corporation makes a section 444 election, it must distribute certain amounts to employee-owners by December 31 of each applicable election year. If it fails to make these distributions, it may be required to defer certain deductions for amounts paid to owner-employees. The amount deferred is treated as paid or incurred in the following tax year.

For information on the minimum distribution, see Schedule H, *Section 280H Limitation for a Personal Service Corporation (PSC),* of Form 8716.

Back-up election. If you have requested, or plan to request, permission to use a tax year that has a business purpose, you can file a section 444 election (if you otherwise qualify) as a backup to your requested business year. If you are denied your request for a business purpose tax year, you can then activate your back-up section 444 election.

Making back-up election. Follow the general rules for making a section 444 election, as discussed earlier. In addition, print "BACK-UP ELECTION" at the top of Form 8716. However, if you file Form 8716 on or after the date you file Form 1128, *Application to Adopt, Change or Retain a Tax Year,* for your requested business purpose year, print at the top of Form 8716 "FORM 1128 BACK-UP ELECTION."

Activating election. Partnerships and S corporations activate their back-up election by making the required payment with Form 8752 and printing at the top of the form, "ACTIVATING BACK-UP ELECTION." The due date for filing Form 8752 and the payment is the later of:

1) May 15 of the calendar year following the calendar year in which the applicable election year begins, or
2) 60 days after the partnership or S corporation has been notified by the IRS that the business year request has been denied.

A personal service corporation activates its back-up election by filing Form 8716 with its original or amended income tax return for the tax year in which the election is first effective, and printing on the top of the income tax return, "ACTIVATING BACK-UP ELECTION."

Business Purpose Tax Year

A business purpose for a tax year is an accounting period that has a substantial business purpose for its existence. Both tax and nontax factors must be considered in determining if there is a substantial business purpose for a requested tax year.

Business purpose. A nontax factor that may be sufficient to establish a business purpose for a tax year is the annual cycle of business activity, called a "natural business year." The accounting period of a natural business year includes all related

income and expenses. A natural business year exists when a business has a peak period and a non-peak period. The natural business year is considered to end at or soon after the end of the peak period.

Other factors. Other nontax factors usually will not be sufficient to establish that a business purpose exists for a particular tax year. These factors are:

1) The use of a particular year for regulatory or financial accounting purposes,
2) The hiring patterns of a particular business, such as the fact that a firm typically hires staff during certain times of the year,
3) The use of a particular year for administrative purposes, such as the admission or retirement of partners or shareholders, promotion of staff, and compensation or retirement arrangements with staff, partners, or shareholders, and
4) The fact that a particular business involves the use of price lists, a model year, or other items that change on an annual basis.

Also, in considering whether there is a business purpose for a tax year, significant weight is given to tax factors. A prime consideration is whether the change would create a substantial distortion of income. Examples of distortion of income are:

1) The deferral of a substantial portion of income, or the shifting of a substantial portion of deductions, from one year to another so as to reduce tax liability,
2) Causing a similar deferral or shifting for any other person, such as a partner or shareholder, and
3) Creating a short period in which there is a substantial net operating loss.

Any deferral of income to partners or shareholders is not a business purpose. For examples of situations in which a substantial business purpose has been established, see Revenue Ruling 87–57 (1987–2 C.B. 687).

Expeditious approval. The Internal Revenue Service has provided an "expeditious approval" procedure for a partnership, an S corporation, or a personal service corporation to retain or change to a natural business year as determined by the 25% test. It also enables an S corporation to adopt, retain, or change to a fiscal year that satisfies the "ownership tax year test," discussed later.

25% test. The natural business year is determined by the 25% test using the method of accounting used for the tax returns for each year involved. To figure the 25% test—

1) Compute gross receipts from sales and services for the most recent 12-month period that ends with the last month of the requested fiscal year. Divide this amount into the gross receipts of the last 2 months of this same 12-month period.
2) Make the same computation for the two 12-month periods immediately preceding the 12-month period used in (1).
3) Compare the results; if each of the three results equals or exceeds 25%, the fiscal year is the natural business year.

If the partnership, S corporation, or personal service corporation qualifies for more than one natural business year, the year producing the highest average of the three percentages is the natural business year.

If the partnership, S corporation, or personal service corporation does not have at least 47 months of gross receipts (which may include a predecessor organization's gross receipts), it cannot use this expeditious procedure to obtain permission to use a fiscal year.

If the requested tax year is a 52–53 week tax year, the calendar month ending nearest to the last day of the 52–53 week tax year is treated as the last month of the requested tax year for purposes of computing the 25% test.

Ownership tax year test. An S corporation or corporation electing to be an S corporation qualifies for expeditious approval if it meets an ownership tax year test. The test is met if the corporation is adopting, retaining, or changing to a tax year and shareholders holding more than 50% of its issued and outstanding shares of stock have, or are all changing to, the same tax year. These shareholders must hold the stock on the first day of the requested tax year. Shareholders that desire to change to the same tax year should follow section 1.442–1(b)(1) of the Income Tax Regulations in requesting permission. If, on the first day of any tax year, the S corporation no longer meets the ownership tax year test, the corporation must change its tax year to a permitted year.

Filing information. To get expeditious approval, a partnership, S corporation, or corporation electing to be an S corporation must file a tax return for the short period. The short tax year return must be filed by the due date, including extensions.

Form 1128 must be filed by the 15th day of the second calendar month following the close of the short period. Form 1128 must be filed with the Director of the Internal Revenue Service Center where a return is normally filed. The envelope should be marked "Attention: Entity Control." In addition, the first page of Form 1128 should have at the top of the statement, "FILED UNDER REV. PROC. 87–32."

A corporation electing to be an S corporation must file its Form 2553, *Election by a Small Business Corporation*, to request to adopt, retain, or change its tax year. The form must be filed at the time the election request is filed. Do not pay the user fee when filing Form 2553. The IRS will notify you when the fee is due. See *User Fees*, earlier.

In some cases, a late filing of Form 1128 may be accepted. However, applications received by the IRS 90 days after the due date will not be approved, except in very unusual and compelling circumstances.

For more information on these tax year requirements, see Revenue Procedure 87–32 (1987–2 C.B. 396) and Revenue Ruling 87–57.

Corporations

A new corporation establishes its tax year when it files its first tax return. An S corporation or a personal service corporation must use the required tax year rules, discussed earlier, to establish its tax year. A newly reactivated corporation, which has been inactive for a number of years, is treated as a new taxpayer for the purpose of adopting a tax year.

Change in Tax Year

A corporation (other than an S corporation, a personal service corporation, or an IC-DISC) may change its tax year without first getting the approval of the IRS if the following conditions are met:

1) It must not have changed its tax year within the 10 calendar years ending with the calendar year in which the short tax year resulting from the change begins,
2) Its short tax year must not be a tax year in which it has a net operating loss,
3) Its taxable income for the short tax year must be (when annualized) 80% or more of its taxable income for the tax year before the short tax year,
4) If it is a personal holding company, foreign personal holding company, an exempt organization, foreign corporation not engaged in a trade or business within the United States, ***either*** for the short tax year or for the tax year before the short tax year, it must have the same status for ***both*** the short tax year and the tax year before, and
5) It must not try to become an S corporation for the tax year that would immediately follow the short tax year required to effect the change.

A statement on behalf of the corporation must be filed with the IRS office where the corporation files its tax returns by the time for filing its return for the short tax year required by the change.

The statement must indicate that the corporation is changing its annual accounting period under section 1.442–1(c) of the Income Tax Regulations and must show that all the preceding conditions have been met. If, on examination, the corporation does not meet all the conditions because of later adjustments in establishing tax liability, the statement will be considered a timely application for permission to change the corporation's annual accounting period to the tax year indicated in the statement.

If the corporation's records are not adequate or the corporation has an accounting period that does not qualify as a fiscal year, the tax year is the calendar year. In this case, if a fiscal year is adopted, it will be treated as a change in the annual accounting period, and the corporation will have to first get approval from the IRS.

Expeditious approval. A procedure is provided whereby certain corporations may expeditiously obtain approval to change their tax year. The procedure applies to a corporation that:

1) Cannot meet the five conditions listed above,
2) Has not changed its annual accounting period within 10 calendar years (ending with the calendar year that includes the beginning of the short period required to effect the change of annual accounting period), and
3) Is not any of the following: a member of a partnership, a beneficiary of a trust or an estate, an S corporation (and the corporation does not attempt to make an S corporation election that is intended to first become effective for the tax year immediately following the short period), an IC–DISC or a shareholder of an IC–DISC, a tax-exempt organization, a cooperative, or a foreign corporation that meets the stock ownership requirements of a foreign personal holding company.

Corporations that qualify and want to change their tax year using this expeditious procedure must comply with the following conditions:

1) The short period required to effect the change in annual accounting period must begin with the day following the close of the old tax year and must end with the day preceding the first day of the new tax year.
2) The books of the corporation must be closed as of the last day of the new tax year. Returns for later years must be made on the basis of a full 12 months or 52–53 weeks ending on the last day of the new tax year. The corporation must figure its income and keep its books and records, including financial reports and statements for credit purposes, on the basis of the new tax year.
3) Taxable income of the corporation for the short period must be figured on an annual basis (annualized) and the tax figured as described under *Short Tax Year*, earlier.
4) If the short period required to effect the change of annual accounting period is a tax year in which the corporation has a net operating loss, the loss is to be deducted ratably over a 6-year period beginning with the first tax year after the short period, unless the corporation meets one of the following exceptions:
   a) If the net operating loss resulting from the short period is $10,000 or less, the net

operating loss can generally be carried back to each of the 3 tax years before the tax year of loss, or carried forward to each of the 15 tax years following the tax year of such loss, or

b) If the net operating loss resulting from a short period of 9 months or longer is greater than $10,000 and is less than the net operating loss for a full 12-month period beginning with the first day of the short period, the net operating loss can be carried back or carried over in the same way referred to in (a) above.

5) If there is any unused credit for the short period, the corporation must carry the unused credit(s) forward. Unused credit(s) from the short period may not be carried back.

A corporation making this change must file Form 1128 with the Director, Internal Revenue Service Center, where the corporation files its income tax return. The form must be filed on or before the 15th day of the second calendar month following the close of the corporation's short tax year.

If the request is denied, the service center will return Form 1128. An explanation of the denial will be provided. If the request is approved, the service center will return a copy of Form 1128 stamped "approved." The corporation must attach the approved Form 1128 to its tax return for the short period. At the top of Form 1128, the corporation should put: "FILED UNDER REV. PROC. 84-34."

If the request is denied, the service center will return Form 1128. An explanation of the denial will be provided. If the request is approved, the service center will return a copy of Form 1128 stamped "approved." The corporation must attach the approved Form 1128 to its tax return for the short period.

Excise Tax Periods

You must account for most federal excise taxes quarterly. Some excise taxes must be paid by July 1 each year, or on the date you become liable for them. The quarters covered, in most cases, are:

Calendar quarter	Calendar months
First	January, February, March
Second	April, May, June
Third	July, August, September
Fourth	October, November, December

Information on excise taxes is available in the following publications: Publication 510, *Excise Taxes for 1991*, Publication 349, *Federal Highway Use Tax on Heavy Vehicles*, and Publication 378, *Fuel Tax Credits and Refunds*.

Employment Tax Periods

You must use the calendar quarter for withheld income taxes and social security taxes. You must use the calendar year for federal unemployment taxes. For information on employment taxes, see Publication 937, *Business Reporting*, and Publication 15, *Circular E, Employer's Tax Guide*.

Accounting Methods

An accounting method is a set of rules used to determine when and how income and expenses are reported. The term "accounting method" includes not only the overall method of accounting you use, but also the accounting treatment you use for any material item. You choose your method of accounting when you file your first tax return. After that, if you want to change your accounting method, you must first get consent from the IRS. See *Change in Accounting Method*, later.

No single accounting method is required of all taxpayers. You must use a system that clearly shows your income and expenses, and you must maintain records that will enable you to file a correct return. In addition to your permanent books of account, you must keep any other records necessary to support the entries on your books and tax returns.

You must use the same method from year to year and figure your taxable income following the accounting method you use to keep your books. This method must clearly show your income and expenses. Any accounting method that shows the consistent use of generally accepted accounting principles for your trade or business generally is considered to clearly show income. An accounting method clearly shows income only if all items of gross income and all expenses are treated the same from year to year.

If you do not regularly use an accounting method that clearly shows your income, your income will be figured under the method that, in the opinion of the IRS, clearly shows your income.

Methods you may use. Subject to the preceding rules, you may figure your taxable income under any of the following accounting methods:

1) Cash method,
2) Accrual method,
3) Special methods of accounting for certain items of income and expenses, and
4) Combination (hybrid) method using elements of (1), (2), or (3).

The cash and accrual methods of accounting are explained later.

Special methods. There are special methods of accounting for certain items of income or expenses that are not discussed in this publication. For information on reporting income using one of the long-term contract methods, see section 460 of the Internal Revenue Code and section 1.451-1 of the Income Tax Regulations. Methods for deducting amortization and depletion are discussed in Publication 535, *Business Expenses*. Other special methods for reporting income or expenses are discussed in the following publications:

Publication 225, *Farmer's Tax Guide*

Publication 534, *Depreciation*

Publication 537, *Installment Sales*

Combination (hybrid) method. Any combination of cash, accrual, and special methods of accounting can be used if the combination clearly shows income and is consistently used. You may specifically use the accrual method for purchases and sales and the cash method for all other items of income and expenses. The following restrictions do apply:

1) If you use the cash method for figuring your income, you must use the cash method for reporting your expenses.
2) If you use the accrual method for reporting your expenses, you must use the accrual method for figuring your income.

Any combination that includes the cash method is treated as the cash method, subject to the limitations applied to that method. See *Limits on Use of Cash Method*, later.

Business and personal items. You may account for business and personal items under different accounting methods. Thus, you may figure the income from your business under an accrual method even though you use the cash method to figure personal items.

Two or more businesses. If you operate more than one business, you may use a different accounting method for each separate and distinct business if the method you use for each clearly shows your income. For example, if you operate a personal service business and a manufacturing business, you may use the cash method for the personal service business, but you must use the accrual method for the manufacturing business.

No business will be considered separate and distinct if you do not keep a complete and separable set of books and records for that business.

Cash Method

The cash method of accounting is used by most individuals and many small businesses with no inventories. However, if inventories are necessary in accounting for your income, you must use the accrual method for your sales and purchases. If you are not required to keep inventories, the cash method is the method you usually will use. However, see *Limits on Use of Cash Method*, later.

Income

With the cash method, you include in your gross income all items of income you actually or constructively receive during the year. You must include property and services you receive in your income at their fair market value.

Constructive receipt. You have constructive receipt of income when an amount is credited to your account or made available to you without restriction. You do not need to have possession of it. If you authorize someone to be your agent and receive income for you, you are treated as having received it when your agent receives it.

Example 1. You have interest credited to your bank account in December 1990. You must include it in your gross income for 1990 and not in 1991 when you withdraw or enter it in your passbook.

Example 2. You have interest coupons that mature and are payable in 1990, but you do not cash them until 1991. You must include them in income for 1990. You must include this matured interest in your gross income even though you later exchange the coupons for other property instead of cashing them.

Delaying receipt of income. You cannot hold checks or postpone taking possession of similar property from one tax year to another to avoid paying tax on the income. You must report the income in the year the property is received or made available to you without restriction.

Expenses

Usually, you must deduct expenses in the tax year in which you actually pay them. This includes business expenses for which you contest liability. However, you may be required to postpone the deduction for expenses you pay in advance. In addition, you may have to capitalize certain costs, explained later.

Expenses paid in advance. Expenses you pay in advance can be deducted only in the year to which they apply.

Example. You are a calendar year taxpayer and you pay $1,000 for a business insurance policy that is effective on July 1, 1990, for a one-year period. You may deduct $500 in 1990, and $500 in 1991.

Limits on Use of Cash Method

The cash method, including any combination of methods that includes the cash method, cannot be used by the following entities:

1) Corporations (other than an S corporation),
2) Partnerships having a corporation (other than an S corporation) as a partner, and
3) Tax shelters.

Exceptions

An exception allows a farming business (with gross receipts of $25 million or less), a qualified personal service corporation, and an entity with average annual gross receipts of $5,000,000 or less to continue using the cash method. However, these exceptions do not apply to tax shelters. For information on the exception for farming businesses, see Publication 225, *Farmer's Tax Guide.*

Qualified personal service corporations. A qualified personal service corporation is a corporation that meets both a function test and an ownership test.

Function test. The function test is met if at least 95% of the activities of the corporation are the performance of service in the fields of health, law, engineering (including surveying and mapping), architecture, accounting, actuarial science, performing arts, or consulting.

Ownership test. The ownership test is met if at least 95% of the stock of the corporation is owned, directly or indirectly, by:

1) Employees performing services for the corporation in a field qualifying under the function test,
2) Retired employees who performed services in such fields,
3) The estate of an employee described in (1) or (2), or
4) Any other person who acquired the stock by reason of the death of an employee referred to in (1) or (2), provided the stock was acquired within 24 months after the employee's death.

Indirect ownership is generally taken into account if the stock is owned indirectly through one or more partnerships, S corporations, or qualified personal service corporations. Stock owned by such an entity is considered owned by the entity's owners in proportion to their ownership interest in that entity. Other forms of indirect stock ownership, such as stock owned by family members, are generally not considered in determining if the ownership test is met.

For purposes of the ownership test, a person is not considered an employee of a corporation unless the services performed by that person for the corporation are more than minimal services.

A corporation that fails the function test for any tax year and fails the ownership test at any time during any tax year must change from the cash method of accounting, effective for the year in which the corporation fails to meet either test. A corporation that fails the function test or the ownership test is not treated as a personal service corporation for any part of that tax year.

$5 million gross receipts test. Any corporation or partnership may use the cash method, if, for all its tax years after 1985, the corporation or partnership meets the $5,000,000 gross receipts test. A corporation or a partnership meets the test if its average annual gross receipts for the 3-tax-year period (or, if shorter, the period of existence) ending with the prior tax year are $5,000,000 or less. Generally, a partnership applies the test at the partnership level. For these rules, gross receipts for a short tax year are annualized.

Failure to meet exceptions. If you fail to meet any of the exceptions for limits on use of the cash method in any tax year, you are required to change to the accrual method of accounting. See *Automatic Change to Accrual Method* under *Change in Accounting Method,* later.

Accrual Method

Under the accrual method of accounting, income generally is reported in the year earned, and expenses are deducted or capitalized in the year incurred. The purpose of the accrual method of accounting is to match your income and your expenses in the correct year.

Income

All items of income are generally included in your gross income when you earn them, even though you may receive payment in another tax year. All events that fix your right to receive the income must have happened and you must be able to figure the amount with reasonable accuracy.

Example. You are a calendar year taxpayer. You sold a radio on November 28, 1990. You billed the customer 3 days later but did not receive payment until February 1991. You must include the amount of the sale in your income for 1990 because you earned the income in 1990.

Estimating income. When you include an amount in gross income on the basis of a reasonable estimate, and you later determine the exact amount, the difference, if any, is taken into account in the year in which the determination is made.

Change in payment schedule for services. If you contract to perform services for a basic rate, you must include the basic rate in your income as it accrues. You must accrue the basic rate even if, as a matter of convenience, you agree to receive payments at a lower rate until you complete your services, at which time you will receive the difference between the basic rate and the amount actually paid to you.

Accounts receivable for services. You may not have to accrue all of your accounts receivable if, based on your experience, you will not collect all of these accounts. This is called the *nonaccrual-experience method,* and is explained in section 1.448–2T(b) of the Income Tax Regulations.

Discounting notes receivable. Discounting notes receivable is a common practice in some businesses. Many dealers receive the notes of customers as part payment for articles sold. These notes are payable over a fixed period. The dealer then sells the notes to a finance company at a discount. The dealer and the finance company often agree that a part of the discount price will be held by the finance company in a ***dealer's reserve*** or similar account until collections are made or the reserve reaches a specified total, at which time it will be paid over or credited to the dealer. In these cases, amounts held in the reserve are treated as income. Under an accrual method of accounting the full amount of the ***discount price,*** not reduced by the reserve held by the finance company, is included in income when the notes are sold. This practice is often followed by automobile dealers.

Losses on worthless notes that the finance company may charge against the reserve have no bearing on the fact that taxable income has been received by the dealer.

Advance Income for Services

If, under an agreement, you receive advance payments for services to be performed by the end of the next tax year, you can postpone including the advance payments in income until you earn them. However, you may not postpone including the payments beyond the following tax year.

Service agreements. You may postpone reporting income from advance payments you receive for service agreements on property you sell, lease, build, install, or construct. This includes agreements providing for incidental replacement of parts or materials. However, this applies only if you offer the property without service agreements in the normal course of business.

Guarantees and warranties. You may not postpone reporting income you receive for guarantee or warranty contracts.

Prepaid rent or prepaid interest. You cannot postpone reporting income from prepaid rent or prepaid interest. Prepaid rent does not include payments for use of rooms or other space when significant services are also provided for the occupant. You provide significant services when you supply space in hotels, boarding houses, tourist homes, motor courts, motels, or apartment houses that furnish hotel services.

General rule. Usually you may not postpone including advance payments if, under the agreement:

1) You are to perform any part of the services after the end of the tax year immediately following the year you receive the advance payments, or
2) You are to perform any part of the services at any unspecified future date that may be after the end of the tax year immediately following the year you receive the advance payments.

Any advance payment that you include in gross receipts in the tax year you receive the payment may not be less than the amount of the payment you include as gross receipts in your books and records and all your reports (including consolidated financial statements) to shareholders, partners, other proprietors or beneficiaries, and for credit purposes.

If you want to defer income as previously described, you must first get consent from the IRS as discussed later under *Change in Accounting Method.*

In each of the examples that follow, assume you use the calendar year and the accrual method of accounting.

Example 1. You manufacture, sell, and service television sets. In 1990 you received payment for a one-year contingent service contract on a television set you sold. You may postpone including these payments in income if, in the normal course of your business, you offer the television sets for sale without the contingent service contracts.

Example 2. You are in the television repair business. In 1990, you received payments for one-year contracts under which you agree to repair or replace certain parts that fail to function properly in television sets that were sold by an unrelated party. You include the payments in gross income as you earn them by performing the services.

In these examples, if for any reason you do not perform part of the services by the end of the following tax year (1991), you must include in gross income for 1991 the amount of the advance payments that are for the unperformed services.

Example 3. You own a dance studio. On November 4, 1990, you received payment for a one-year contract beginning on that date and providing for 48 one-hour lessons. You gave eight lessons in 1990. Under this method of including advance payments, you must include one-sixth (8/48) of the payment in income for 1990, and five-sixths (40/48) of the payment in 1991, even if you cannot give all the lessons by the end of 1991.

Advance Income from Sales

Any advance payments you receive for future sales or other dispositions of goods are included in your income under special rules. Under these rules, advance payments include those you receive under an agreement for future sales of goods you hold primarily for sale to your customers in the ordinary course of your trade or business.

The special rules may not apply to that part of any advance payment you receive for services that are not an integral part of your main activities under the agreement. An agreement also means a

gift certificate that can be redeemed for goods. Amounts that are due and payable are treated as received.

Inclusion in income. You may choose when to report the advance payments in income. You may include them in income in the tax year in which you receive them, or under an alternative method.

Alternative method. Under an alternative method, you generally include advance payments in income in the *earlier* tax year in which:

1) You include the advance payments in gross receipts under the method of accounting that you use for tax purposes, or
2) You include any part of the advance payments in any of your financial reports under the method of accounting used for those reports.

Your financial reports include your reports to shareholders, partners, beneficiaries, other proprietors, for credit purposes, and for consolidated financial statements.

Example 1. You are a retailer who uses an accrual method of accounting under which you account for your sales of goods when you ship the goods. You use this accounting method for both tax and reporting purposes. Therefore, you must include advance payments you receive in gross receipts for tax purposes either in the tax year you receive the payments or in the tax year you ship the goods.

Example 2. You are a calendar year taxpayer who manufactures household furniture. You use the accrual method of accounting. Under your method of accounting you accrue income for your financial reports when you ship the furniture. For tax purposes, you do not accrue income until the furniture has been delivered and accepted.

In 1989 you received an advance payment of $8,000 from a customer for an order of furniture to be manufactured for a total price of $20,000. You shipped the furniture to your customer in December 1989, but it was not delivered and accepted until January 1990. You must include the entire $8,000 advance payment in your gross income for tax purposes in 1989. You include the remaining $12,000 of the contract price in your gross income, for tax purposes, in 1990.

Exception for inventory goods. If you receive advance payments under an agreement for the sale of goods that are properly included in your inventory, or under an agreement such as a gift certificate, that can be satisfied with goods or a type of goods that cannot be identified in the year of sale, you may be able to postpone including the advance payments in income in the year of receipt. The postponement period for these advance payments may extend only until the end of the second tax year following the year in which you received an advance payment and met the following conditions:

1) You must account for advance payments under the alternative method as discussed earlier,
2) You must have received substantial advance payments (discussed later) on the agreement, and
3) You must have on hand or available to you through your normal source of supply in that year enough substantially similar goods to satisfy the agreement.

If you meet these conditions at the end of a tax year, all advance payments (not included in income under your accrual accounting method) that you receive by the end of the second following tax year must be included in income for that second year. Also at the end of this second year you must deduct all actual or estimated costs of goods necessary to satisfy the contract.

Any difference between the estimated and the actual costs in fulfilling the contract must be taken into account when the goods are delivered. After this period any more advance payments received on this contract are reported in income in the year received because no further deferral is allowable on this contract.

Substantial advance payments. Under an agreement for a future sale, substantial advance payments are considered received by the end of a tax year. But the total advance payments received during the current and preceding tax years must be equal to or more than the total costs and expenditures reasonably estimated to be includable in inventory because of the agreement.

Example. You are a calendar year, accrual method taxpayer who accounts for advance payments under the alternative method as discussed earlier. In 1987 you entered into a contract for the sale of goods that are properly includable in your inventory. The total contract price is $50,000 and you estimate that your total inventoriable costs for the goods will be $25,000. You received the following advance payments under the contract:

1987	$17,500
1988	10,000
1989	7,500
1990	5,000
1991	5,000
1992	5,000
Total contract price	$50,000

Your customer asked you to deliver the goods in 1993. In your 1988 closing inventory you had enough of the type of goods specified in the contract on hand to satisfy the contract. Since the advance payments you had received by the end of 1988 were more than the costs you estimated you would have, the payments are substantial advance payments.

Include all payments you receive by the end of 1990, the second tax year following the tax year in which you receive substantial advance payments, in income for 1990. Therefore, you must include $40,000 in income for 1990, and you must include in your cost of goods sold the cost of the goods (or similar goods) on hand or, if no such goods are on hand, the estimated costs necessary to satisfy the contract.

Because no further deferral is allowable for the contract, you must include in your gross income for each remaining year of the contract the advance payment you receive that year. Any difference between the estimated costs and the costs you actually have in satisfying the contract is to be taken into account in 1993, when you deliver the goods.

Information schedule. If you use this alternative method of treating advance payments for future sales of goods, you must attach to your income tax return for each tax year a statement that shows:

1) Total advance payments you received in the current tax year,
2) Total advance payments you received in earlier tax years that you have not included in income before the current tax year, and
3) Total payments you received in earlier tax years that you have included in income for the current tax year.

To change to the alternative method, you must first get consent from the IRS.

Expenses

You deduct, or capitalize, business expenses when you become liable for them, whether or not you pay them in the same year. All events that set the amount of the liability must have happened, and you must be able to figure the amount with reasonable accuracy.

Economic Performance Rule

Generally, you cannot deduct business expenses until economic performance occurs. If your expense is for property or services provided to you, or for use of property by you, economic performance occurs as the property or services are provided, or as the property is used. If your expense is for property or services that you provide to others, economic performance occurs as you provide the property or services.

Example. You are a calendar year taxpayer and in December 1990 you buy office supplies. You receive the supplies and the bill for them in December, but you pay for the supplies in January 1991. You can deduct the expense in 1990 because (1) all events that set the amount of liability and (2) economic performance occurred in that year. Your office supplies may qualify as a recurring expense, discussed later, permitting you to deduct them in 1990 even if the delivery of the supplies (economic performance) does not occur until 1991.

Workers' compensation and tort liabilities. A special rule is provided for workers' compensation and tort liabilities. If you are required to make payments under workers' compensation laws, or in satisfaction of any tort, economic performance occurs as you make the payments.

Settlement fund. Economic performance occurs as qualified payments are made to a court-established designated settlement fund.

Interest. Economic performance occurs with the passage of time (as the borrower uses, and the lender forgoes use of, the lender's money) rather than as payments are made. Interest accruing on obligations incurred after June 8, 1984, and not incurred under a written contract binding on March 1, 1984, and at all times thereafter, is deductible only by using a constant interest method that corresponds to the actual economic accrual of interest.

Compensation for services. Generally, economic performance occurs as an employee renders his or her services to the employer. However, an employer's deduction for compensation or other benefits paid to an employee in a year subsequent to economic performance is subject to the rules governing deferred compensation, deferred benefits, and funded welfare benefit plans.

Vacation pay. You can deduct vacation pay earned by your employees only if you pay it during the year or, if not treated as deferred compensation, within 2½ months after the close of the year. If paid later, you can deduct the vacation pay in the year actually paid.

Recurring items. An exception allows you to treat certain recurring items as incurred during a tax year even though economic performance has not occurred. In this case, you may be able to deduct an expense in 1990, even though economic performance does not occur until 1991. The exception applies if all the following conditions are met:

1) The all-events test, without regard to economic performance, is satisfied during the tax year,
2) Economic performance occurs within the shorter of: 8½ months, or a reasonable time after the close of the tax year,
3) The item is recurring in nature and you consistently treat similar items as incurred in the tax year in which the all-events test is met, and
4) Either (a) the item is not material or (b) accrual of the item in the year in which the all events test is met results in a better match against income than would result from accruing the item in the year of economic performance.

The exception for recurring items does not apply to workers' compensation or tort liabilities.

Recurrency and consistency. To determine whether an item is recurring and is consistently reported, consider the frequency with which the item and similar items are incurred (or expected to be incurred) and the way in which you report these items for tax purposes. The exception is intended to be available if you are either starting up a trade or business or you are already in a trade or business. In addition, a new type of expense or an expense that does not recur every year is not necessarily excluded from this exception.

Materiality. Factors to consider in determining the materiality of a recurring item include the size of the item (both in absolute terms and in relation to your income and other expenses) and the treatment of the item on your financial statements. An item considered material for financial statement purposes is also considered material for tax purposes.

For example, you are a calendar year taxpayer and you enter into a one-year maintenance contract on July 1, 1990. If you prorate your expenses between 1990 and 1991 for financial statement purposes, you should do the same for tax purposes. However, if you deduct the full amount in 1990 for financial statement purposes because of its immateriality under generally accepted accounting principles, that expense is not necessarily immaterial for purposes of the recurring item exception.

In some situations, an item that is not material for financial accounting purposes is treated as material for purposes of economic performance. If an item is directly related to an activity, the materiality of the item will be separately determined for that activity. The materiality of overhead expenses that relate to several of your activities is measured against those collective activities.

Matching. To determine whether the accrual of an item in a particular year results in a better matching of the item with the income to which it relates, generally accepted accounting principles are an important factor. Costs directly associated with the revenue of a period are properly allocable to that period.

For example, a sales commission agreement may require certain payments to be made in a year subsequent to when sales income is reported. In this situation, economic performance for part of the commission expense may not occur until the following year. Nevertheless, if you deduct the expense in the year the sales income is reported it will result in a better matching of the commission expense with the sales income. In addition, if sales income is recognized in one year, but the goods are not shipped until the following year, the shipping costs are more properly matched to income in the year the goods are sold than in the year the goods are shipped.

Expenses such as insurance or rent are generally allocable to a period of time. Thus, if you are a calendar year taxpayer and enter into a 12-month insurance contract on July 1, 1990, allocate half of your expense to 1990 and half to 1991. In some situations, however, an expense may be immaterial and entirely accruable in 1990. Expenses such as advertising costs that cannot be practically associated with income of a particular period should be assigned to the period in which the costs are incurred. The matching requirement is satisfied for advertising expenses if the period to which the expenses are assigned is the same for tax and financial reporting purposes.

Special Rules for Related Persons

You cannot deduct business expenses and interest owed to a related cash basis person ***until*** you make the payment and the corresponding amount is includable in the gross income of the related person. Determine the relationship, for this rule, as of the end of the tax year for which the expense or interest would otherwise be deductible. If a deduction is denied under this rule, the rule will continue to apply even if your relationship with the person ends before the expense or interest is includable in the gross income of that person.

Related persons. For the purpose of this rule, the following are related persons:

1) Members of the immediate family, including only brothers and sisters (either whole or half), husband and wife, ancestors, and lineal descendants,
2) Two corporations that are members of the same controlled group,
3) The fiduciaries of two different trusts, and the fiduciary and beneficiary of two different trusts if the same person is the grantor of both trusts,
4) Certain educational and charitable organizations and a person (if an individual, including the members of the individual's family) who, directly or indirectly, controls the organization,
5) An individual and a corporation of which more than 50% of the value of the outstanding stock is owned, directly or indirectly, by or for that individual,
6) A trust fiduciary and a corporation of which more than 50% in value of the outstanding stock is owned, directly or indirectly, by or for the trust or by or for the grantor of the trust,
7) The grantor and fiduciary, and the fiduciary and beneficiary, of any trust,
8) Any two S corporations if the same persons own more than 50% in value of the outstanding stock of each corporation,
9) An S corporation and a corporation that is not an S corporation if the same persons own more than 50% in value of the outstanding stock of each corporation, and
10) A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest, or profits interest, in the partnership.

Indirect ownership of stock. To decide whether an individual directly or indirectly owns any of the outstanding stock of a corporation, the following rules apply:

1) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is treated as being owned proportionately by or for its shareholders, partners, or beneficiaries,
2) An individual is treated as owning the stock owned, directly or indirectly, by or for the individual's family (as defined in item (1) under *Related persons),*
3) Any individual owning (other than by applying rule (2)) any stock in a corporation is treated as owning the stock owned directly or indirectly by that individual's partner, and
4) Stock constructively owned by a person under rule (1), (2), or (3), is treated as actually owned by that person. But stock constructively owned by an individual under rules (2) or (3) will not be treated as actually owned by the individual for applying either rules (2) or (3) to make another person the constructive owner of that stock.

Reallocation of income and deductions. Where it is necessary to clearly show income or to prevent evasion of taxes, the IRS may reallocate gross income, deductions, credits, or allowances between two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests.

Contested Liabilities

You may deduct certain contested liabilities, such as taxes (except foreign income taxes), in the tax year in which you pay them, or transfer money or other property to satisfy the obligation, rather than in the tax year in which the contest is settled. However, to be able to take the deduction in the year of payment or transfer, you must satisfy each of the following rules.

Liability must be contested. You do not have to start a suit in a court of law to contest an asserted liability. However, you must deny its validity or accuracy by a positive act. A written protest included with payment of an asserted liability is enough to start a contest. Lodging a protest in accordance with local law is enough to contest an asserted liability for taxes. You do not have to deny the validity or accuracy of an asserted liability in writing if you can show by all the facts and circumstances that you have asserted and contested the liability.

Transfer to creditor. You must transfer to the creditor or other person enough money or other property to cover the payment of the asserted liability. The money or other property transferred must be beyond your control. If you transfer it to an escrow agent, you have met this requirement if you give up all authority over the money or other property. However, buying a bond to guarantee payment of the asserted liability, making an entry on your books of account, or transferring funds to an account within your control will ***not*** meet this requirement.

Contest must exist. The contest for the asserted liability must exist after the time of the transfer. If you do not make payment until after the contest is settled, you must accrue the liability in the year in which the contest is settled.

Example. You are a calendar year taxpayer using the accrual method of accounting. In 1988 you had a $500 liability asserted against you for repair work completed in that year. You contested this asserted liability and finally settled in 1990 for the full $500. You pay the $500 in January 1991. Even though you did not make the payment until after the contest was settled, the liability accrues and can only be deducted in 1990.

Liability deduction. The liability must have been allowable as a deduction in the year of payment, or in an earlier year when it would have accrued, if there had been no contest.

Economic performance rule. You generally cannot deduct contested liabilities until economic performance occurs. For workers' compensation or tort liabilities, economic performance occurs as payments are made to the person. The payment or transfer of money or other property into escrow to contest an asserted liability is not a payment to the claimant that discharges the liability. Such payment does not satisfy the economic performance test discussed earlier.

Recovered amounts. An adjustment is usually necessary when you recover any part of a contested liability. This occurs when you deduct the liability in the year of payment and recover any part of it in a later tax year when the contest is settled. You do this by including in gross income in the year of final settlement the part of the recovered amount that, when deducted, decreased your tax for any tax year.

Foreign taxes and taxes of U.S. possessions. The rule allowing the deduction of contested liabilities in the tax year of payment does not apply to the ***deduction*** for income, war profits, and excess profits taxes imposed by any foreign government or U.S. possession. Thus, an accrual method taxpayer deducts these liabilities in the tax year in which the contested foreign tax or U.S. possession tax is finally determined. Contested foreign taxes accrued for ***credit*** are not covered under this provision but relate back and are

credited in the tax year in which they would have been accrued if they had not been contested.

Inventories

Inventories are necessary to clearly show income when the production, purchase, or sale of merchandise is an income-producing factor. If you must account for inventories in your business, you must use the accrual method of accounting for your purchases and sales. See *Accrual Method*, discussed earlier.

The most common kinds of inventories are:

1) Merchandise or stock in trade,
2) Raw materials,
3) Work in process,
4) Finished products, and
5) Supplies (that become a part of the item intended for sale).

The value of inventories at the beginning and end of each tax year is required to determine taxable income. To determine the value of your inventory, you need a method for ***identifying*** the items in your inventory and a method for ***valuing*** these items.

Inventory valuation rules cannot be the same for all kinds of businesses. The method you use must conform to generally accepted accounting practices used for similar businesses, and it must clearly show income. To clearly show income, you must consistently use the same inventory method from year to year.

The value of your inventory may include certain capitalized costs. These rules are explained later under *Uniform Capitalization Rules*.

Items included in inventories. Inventories include all your finished or partly finished goods and raw materials and supplies that become a part of the merchandise you intend to sell.

Merchandise. Merchandise should be included in your inventory only if you have title to it. You should include merchandise you purchase in inventory if title to it has passed to you, even though it is in transit or you do not have physical possession of it for some other reason. Your inventory should also include the following:

1) Goods under contract for sale that you have not yet segregated and applied to the contract,
2) Goods out on consignment, and
3) Goods that are in display rooms, merchandise mart rooms, or booths that are located away from your place of business.

In figuring gross income, you may be permitted to account for the sale of your product when the goods are shipped, when the product is delivered or accepted, or when title to the goods passes to the customer, whether or not billed, depending upon the method you use for keeping your books. Do not include the goods you sold in your inventory.

Containers. Containers such as kegs, bottles, and cases, whether or not on hand and whether or not returnable, should be included in your inventory if title to them has not passed to a buyer of the contents. If title has passed to a buyer, you should exclude the containers from your inventory. Under certain circumstances, some containers may be depreciated. See Publication 534, *Depreciation*.

C.O.D. mail sales. If you sell merchandise by mail and intend payment and delivery to happen at the same time, title passes when payment is made. Include the merchandise in your closing inventory until the buyer pays for it.

Items excluded from inventory. Exclude from your inventory all goods you have sold, but be sure that the title to them has passed to the buyer. Also exclude goods in your possession that are consigned to you and goods you ordered for future delivery if you do not yet have title to them.

Assets. Assets such as land, buildings, and equipment used in your business, as well as notes and accounts receivable, and similar assets, are not included in inventory. Also, real estate held for sale by a real estate dealer in the ordinary course of business is not included in inventory.

Special rules apply to the cost of inventory or property imported from a related person. See the regulations under section 1059A of the Internal Revenue Code.

Cost Identification

There are three methods of identifying items in inventory—specific identification, first-in first-out (FIFO), and last-in first-out (LIFO).

Specific Identification Method

The specific identification method is used to identify the cost of each inventoried item by matching the item with its cost of acquisition in addition to other allocable costs, such as labor and transportation.

If there is no specific identification of items with their costs, you must make an assumption to decide which items were sold and which remain in inventory. Make this identification by either the first-in first-out method, or the last-in first-out method.

FIFO and LIFO Methods

The ***first-in first-out (FIFO) method*** assumes that the items you purchased or produced first are the first items you sold, consumed, or otherwise disposed of.

The items in inventory at the end of the tax year are valued as the items most recently purchased or produced. If there is intermingling of the same type of goods in your inventory so that they cannot be identified with specific invoices, you must use the FIFO method to value these items, unless you elect to use the last-in first-out (LIFO) method.

The ***last-in first-out (LIFO) method*** assumes that the items of inventory that you purchased or produced last are sold or removed from inventory first. Thus, items included in your closing inventory are considered to be those from the opening inventory plus those items acquired in the current year in the LIFO order.

The FIFO method and the LIFO method produce different results in income depending on the trend of price levels of the goods included in those inventories. In times of inflation, when prices are rising, LIFO will produce a larger cost of goods sold and a lower closing inventory. Under FIFO, the cost of goods sold will be lower and the closing inventory will be higher. However, in times of falling prices, LIFO will produce a smaller cost of goods sold and a higher closing inventory. Under FIFO the reverse will be true.

Adopting LIFO method. To adopt the LIFO method, you are required to file Form 970, *Application To Use LIFO Inventory Method*, or a statement that has all the information required in Form 970. You must file the form (or the statement) with your timely-filed tax return for the year in which you first use LIFO.

There are very complex rules involved in using the LIFO method. Only two are briefly discussed here.

Dollar-value method. Under the dollar-value method of pricing LIFO inventories, goods and products have to be grouped into one or more pools (classes of items), depending on the kinds of goods or products in the inventories. For more information, see section 1.472–8 of the Income Tax Regulations.

Simplified dollar-value method. An eligible small business may elect the simplified dollar-value LIFO method. An eligible business is one with average annual gross receipts of $5,000,000 or less for the 3 preceding tax years. This method establishes multiple inventory pools in accordance with general categories of inventory items set forth in applicable government price indexes and uses the change in those published indexes to estimate the annual changes in prices for inventory items in the pools. For more information, see section 474 of the Internal Revenue Code and section 1.472–8(e)(3) of the Income Tax Regulations.

Valuing Inventory

Since valuing the items in your inventory is a major factor in figuring your taxable income, the way you value your inventory is very important. The two common ways to value your inventory if you use the FIFO method are the ***specific cost identification*** method and the ***lower of cost or market*** method.

The rules discussed below apply only if they do not conflict with the uniform capitalization rules, discussed later.

For a new business using FIFO, you may use either the specific cost method or the lower of cost or market method to value your inventory. You must use the same method to value your entire inventory, and you may not change to another method without consent from the IRS.

Several pricing methods, which you may use to figure the correct cost basis of your inventory, are recognized for tax purposes. The dollar value that results is the cost basis of your inventory.

Specific cost identification method. The cost of merchandise you purchase during the year is the cost of acquisition in addition to costs allocable to the merchandise. If you use the specific cost identification method to figure the inventory value of merchandise, materials, or supplies, cost means:

1) The inventory price of goods on hand at the beginning of the tax year, and
2) The invoice price (and the indirect costs allocable to such goods) less appropriate discounts for goods purchased during the year. Transportation or other necessary charges you have in acquiring goods are added to the net invoice price.

Discounts. You must reduce the cost of your inventory by trade (or quantity) discounts. Generally, these discounts are for volume or quantity purchases. If a discount is allowed regardless of time of payment, it is a trade discount.

You may or may not deduct cash discounts at your option, but you must treat them the same way from year to year. If you do not deduct the cash discounts from your inventory costs, you must include them in your business income. See *Uniform Capitalization Rules*, later, for additional costs that may have to be included in the inventoriable cost of goods.

Lower of cost or market method. Lower of cost or market means that you compare the market value of each item on hand at the inventory date with its cost and use the lower value as its inventory value. Thus, if at the end of your tax year you had the following items on hand, the value of closing inventory would be $600.

Items	Cost	Market	Whichever is lower
R	$300	$500	$300
S	200	100	100
T	450	200	200
Totals	$950	$800	$600

If you use this method, you must value each item in the inventory. You may not value the entire inventory at cost ($950) and at market ($800) and use the lower of the two figures. If you use the

specific cost identification method, the value of your closing inventory would be $950.

Market value. Under ordinary circumstances and for normal goods, market value means the usual bid price at the date of your inventory. This price is based on the volume of merchandise you usually buy. Thus, if you buy items in small lots at $10 an item and a competitor buys identical items in larger lots at $8.50 an item, your usual market price will be higher than your competitor's.

The lower of cost or market rule applies to goods purchased and on hand, and to basic elements of cost (direct materials, direct labor, and an allocable share of indirect costs) of goods in process of manufacture and finished goods on hand. It does not apply to goods on hand or in process of manufacture for delivery at fixed prices on a firm sales contract (that is, not legally subject to cancellation by either you or the buyer). These goods must be inventoried at cost.

Lower than market. When, in the regular course of business, you have offered merchandise for sale at prices lower than market, the inventory may be valued at these prices, less the direct costs of disposition. Figure these prices from the actual sales for a reasonable period before and after the date of your inventory. Prices significantly different from the actual prices determined are not acceptable.

No market exists. If no market exists, or if quotations are given without reference to actual conditions because of an inactive market, you must use whatever evidence of a fair market price is available, at the dates nearest your inventory date. This evidence could include specific purchases or sales you or others made in reasonable volume and in good faith, or compensation paid for cancellation of contracts for purchase commitments.

Unsalable goods. Unsalable goods are goods in your inventory that you cannot sell at normal prices or in the usual way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes including secondhand goods taken in exchange. You should value these goods at selling prices minus direct costs of disposition no matter what method you use to value the rest of your inventory. If these goods consist of raw materials or partly finished goods held for use or consumption, they must be valued on a reasonable basis, considering the usability and condition of the goods. Do not value them for less than scrap value.

Perpetual or book inventories. It is acceptable to figure the costs of goods on hand by perpetual or book inventories if they are kept by following sound accounting practices. Inventory accounts, however, must be charged with the actual cost of goods purchased or produced, and credited with the value of goods used, transferred, or sold. Credits must be figured on the basis of the actual cost of goods acquired during the year and the inventory value at the beginning of the year.

Physical inventories. You must take physical inventories at reasonable intervals and the book figure for inventory must be adjusted to agree with the actual inventory.

Practices not approved. The following are some of the inventory practices that are not recognized for tax purposes:

1) Deducting a reserve for price changes or an estimated amount for depreciation in the value of your inventory,
2) Taking work in process or other parts of your inventory at a nominal price or less than its full value,
3) Omitting part of your stock on hand,
4) Using a constant price or nominal value for so-called normal quantity of materials or goods in stock,
5) Including stock in transit, shipped either to or by you, the title to which you do not hold,
6) Dividing indirect production costs into fixed and variable production cost classifications and then allocating only the variable costs to cost of goods produced while treating fixed costs as period costs that are currently deductible (the direct cost method), or
7) Treating all or almost all indirect production costs (whether fixed or variable) as period costs that are currently deductible (the prime cost method).

Loss of inventory. A casualty or theft loss of inventory, including items you hold for sale to customers, is automatically claimed through the increase in the cost of goods sold by properly reporting your opening and closing inventories. This loss should not be claimed again as a casualty or theft loss. If you take the loss automatically through the increase in the cost of goods sold, any insurance or other reimbursement you receive for the loss must be included in gross income.

You can choose to take the loss separately. If you take the loss separately, you must eliminate the items by making a downward adjustment to opening inventory or to purchases.

If you take the loss separately, you should reduce the loss by the amount of the reimbursement you received rather than include that amount in gross income. If you do not receive the reimbursement by the end of the year, you may not claim a loss to the extent that you have a reasonable prospect of recovery.

Reimbursement from creditors or suppliers. If your creditors forgive part of what you owe them because of your inventory loss, this amount is treated as a reimbursement. It is accounted for in the same manner as a reimbursement from insurance.

Disaster loss to inventory. If your inventory loss is due to a disaster in an area determined by the President of the United States to be eligible for federal assistance, you may choose to deduct your loss on your return for the immediately preceding year. However, you must decrease your opening inventory for the year of the loss so that the loss will not show up again in inventories.

Uniform Capitalization Rules

Under the uniform capitalization rules, you are required to capitalize direct costs and an allocable portion of most indirect costs that benefit or are incurred because of production or resale activities. This means that certain expenses you have during the year will be included in the basis of property you produce or in your inventory costs, rather than claimed as a current deduction. You will recover these costs through depreciation, amortization, or cost of goods sold when you use, sell, or otherwise dispose of the property.

You are subject to the uniform capitalization rules if you:

1) Produce real or tangible personal property for use in a trade or business or an activity engaged in for profit,
2) Produce real or tangible personal property for sale to customers, or
3) Acquire property for resale, but not personal property if your average annual gross receipts are not more than $10,000,000.

You produce property if you construct, build, install, manufacture, develop, improve, create, raise, or grow the property. Property produced for you under a contract is treated as produced by you to the extent that you make payments or otherwise incur costs in connection with the property.

Tangible personal property includes films, sound recordings, video tapes, books, artwork, photographs, or similar property. However, freelance authors, photographers, and artists are exempt from the uniform capitalization rules if they qualify as explained next under *Exceptions*.

Exceptions. The uniform capitalization rules do not apply to the following types of property:

1) Property used for personal or nonbusiness purposes, or for purposes not connected with a trade or business or an activity conducted for profit,
2) Costs paid or incurred by a freelance writer, photographer, or artist, or a qualified employee owner of a personal service corporation in the business of being a writer, photographer, or artist,
3) Property you produce under a long-term contract,
4) Personal property you purchase for resale if your average annual gross receipts are $10,000,000 or less. See *Retailers and Wholesalers*, later,
5) Property produced for your use if substantial construction had occurred before March 1, 1986,
6) Costs allocable to "cushion gas," and
7) Certain intangible drilling and development costs of oil and gas, or geothermal wells, or other mineral property.

Special exceptions to the capitalization rules apply to farming businesses. See Publication 225, *Farmer's Tax Guide*.

Freelance writers, photographers, and artists. A freelance writer, photographer, or artist is a self-employed individual whose personal efforts create (or may reasonably be expected to create) certain properties.

This exception does not include expenses related to printing, photographic plates, motion picture films, video tapes, or similar items.

A writer is an individual who creates a literary manuscript, a musical composition (including any accompanying words), or a dance score.

A photographer is an individual who creates a photograph or photographic negative or transparency.

An artist is an individual who creates a picture, painting, sculpture, statue, etching, drawing, cartoon, graphic design, or original print edition. The originality and uniqueness of the item created and the predominance of aesthetic value over utilitarian value of the item created is taken into account. Therefore, this generally excludes the production of jewelry, silverware, pottery, furniture, and other similar household items.

Personal service corporations. This exemption for writers, photographers, and artists also applies to the expense of a personal service corporation which directly relates to the activities of the qualified employee-owner. A "qualified employee-owner" is an individual who is a writer, photographer, or artist, and who owns (including ownership by members of his or her family) substantially all of the stock of the corporation.

Special rule for film or video tapes. An individual who creates a film or video tape with no more than minimal help from others, such as assistance in carrying equipment, can use a special 3-year rule to comply with the uniform capitalization rules. The film or tape must be created by the individual without the assistance of actors, musicians, or similar support persons. For information about this rule, see Notice 88–62 (1988–1 C.B. 548).

Direct costs. Direct material costs and direct labor costs incurred for production or resale property must be capitalized. All other costs are indirect costs.

Direct material costs include the cost of those materials that become an integral part of the asset

plus the cost of materials that are used in the ordinary course of the production of the asset.

Direct labor costs include the cost of labor that can be identified or associated with a particular activity. This includes all types of compensation (basic, overtime, sick, vacation, etc.) plus payroll taxes and payments to a supplemental unemployment benefit plan.

Indirect costs. Indirect costs are all costs other than direct material and direct labor costs. Indirect costs that directly benefit or are incurred by reason of a production or resale activity must be capitalized. Costs that benefit production or resale activities as well as other activities require a reasonable allocation to determine the portion that is attributable to each of your activities.

Indirect costs that must be capitalized for production or resale activities include amounts incurred for:

1) Repair and maintenance of equipment or facilities.
2) Utilities (heat, light, and power, etc.) relating to equipment or facilities.
3) Rent of equipment, or land, or facilities.
4) Indirect labor and contract supervisory wages, including payroll taxes and payments to supplemental unemployment benefit plans.
5) Indirect materials and supplies.
6) Tools and equipment that are not otherwise capitalized.
7) Quality control and inspection.
8) Taxes (other than state, local, and foreign income taxes) that relate to labor, materials, supplies, equipment, land, or facilities. This does not include taxes that are treated as part of the cost of property.
9) Depreciation, amortization, and cost recovery allowances on equipment and facilities.
10) Depletion (whether or not in excess of cost). This is not capitalized until such property is sold.
11) Administrative costs, whether or not performed on a job site, but not including any cost of selling, or any return on capital.
12) Direct and indirect costs incurred by any administrative, service, or support function or department, to the extent such costs are allocable to particular activities.
13) Compensation paid to officers attributable to services performed in connection with particular activities (but not including any cost of selling).
14) Insurance on your plant, machinery, or equipment, or insurance on a particular activity.
15) Deductible contributions paid to or under a stock bonus, pension, profit-sharing, or annuity plan.
16) Rework labor, scrap, and spoilage.
17) Bidding costs incurred in the solicitation of contracts that you are awarded.
18) Engineering and design costs.
19) Storage and warehousing costs, purchasing costs, handling, processing, assembly, and repackaging costs, and a part of general and administrative costs.

Interest. Interest on debt incurred or continued to finance the production of real or tangible personal property is included in inventory costs. However, interest on debt incurred or continued to finance the acquisition and holding of property for resale is excluded from the capitalization rules. For more information on the capitalization of interest costs, see Publication 535, *Business Expenses*, and Notice 88–99 (1988–2 C.B. 422).

Past service pension costs. Contributions to a pension plan for past or current services are subject to the uniform capitalization rules. In the case of property that is inventory in your hands, an allocable portion of past service pension costs must be included in inventory that is subject to the uniform capitalization rules.

Costs provided by a related person. Generally, if materials, labor, or services are provided to you by a related person for a price that is less than the arm's-length charge for such items, both you and the related person must account for the transaction as if you purchased the items for their arm's-length charge. Thus, for example, you must capitalize an amount equal to the arm's-length charge for the items and the related person must include in income an amount equal to the arm's-length charge.

Costs not capitalized. You can take a current deduction for certain costs. These costs, which are not required to be capitalized with respect to production or resale activities, include amounts incurred for:

1) Marketing, selling, advertising, and distribution costs,
2) Bidding expenses incurred in the solicitation of contracts not awarded to you,
3) General and administrative expenses (other than those determined to be indirect expenses, discussed earlier), and compensation paid to officers attributable to the performance of services that do not directly benefit or are not incurred by reason of a particular production activity,
4) Research and experimental costs allowable as a deduction under Internal Revenue Code section 174,
5) Losses deductible under Internal Revenue Code section 165,
6) Income taxes,
7) Costs attributable to strikes,
8) Depreciation, amortization, and cost recovery allowances on equipment and facilities that are temporarily idle, and
9) Repair expenses that do not relate to production.

Practical capacity. The practical capacity concept is any method, procedure, or formula under which fixed costs are not capitalized because of the relationship between the actual production at your production facility and the practical or theoretical capacity of your facility. You cannot use the practical capacity concept in accounting for costs under the uniform capitalization rules.

Allocation Methods

There is more than one method that can be used to allocate costs. The subject is discussed briefly here. For more information, see the regulations under section 263A of the Internal Revenue Code and Notice 88–86 (1988–2 C.B. 401).

Direct labor. Direct labor costs incurred during the tax year are generally allocated to or among activities using a specific identification or tracing method. However, direct labor costs may be allocated to or among particular activities using any method, provided that the method used reasonably allocates direct labor costs among such activities. For the purpose of allocating elements of direct labor cost (other than basic compensation) to particular activities, all such cost elements can be grouped together and then allocated to or among activities in proportion to the charge for basic compensation.

You must capitalize all of your direct costs. However, you will not be treated as using an incorrect method of accounting if you treat any direct costs as indirect costs, provided such costs are capitalized to the extent discussed under *Indirect costs*.

Direct materials. The cost of direct materials must generally be allocated to the activity using the method of accounting you use for the inventories containing the materials (such as specific identification, FIFO, LIFO). Direct materials that are not accounted for by this method are allocated to an activity using a tracing method or any other method that reasonably allocates such direct material costs among materials.

Indirect costs. Certain indirect costs must be allocated to or among production or resale activities. They must be allocated to particular activities using either a specific identification or tracing method, the standard cost method, or a method using burden rates (such as ratios based on direct costs, hours, or other items, or similar formulas). However, the method used for this allocation must reasonably allocate these indirect costs among production or resale activities. Usually, indirect costs may be allocated to production and resale activities on the basis of direct labor and material costs, direct labor hours, or any other basis that results in a reasonable allocation of indirect costs.

Administrative, service, or support costs. Allocate total direct and indirect costs (service costs) of administrative, service, or support functions or departments (service departments) by any reasonable, consistent method of cost allocation, described earlier under *Indirect costs*. Allocate service department costs by reasonable methods, such as the direct allocation method or the step-allocation method. A method is not considered reasonable that allocates service department costs to other service departments in a way that avoids reallocating such costs to production and resale activities if such reallocation would otherwise be required.

Simplified production method. If you produce inventory, you can use a simplified method to account for the additional costs that you must allocate. The method can be used for:

1) Stock in trade or other property properly included in your ending inventory.
2) Property held by you primarily for sale to customers in the course of your trade or business.
3) Property you construct for use in your trade or business if you also produce property in (1) or (2), and the property constructed is substantially identical to, and produced in the same manner as, the inventory property or other allowed property.
4) Property you construct for use in your trade or business if you normally produce this property on a routine and repetitive basis.

The simplified production method is designed to lessen the burdens of complying with the new capitalization rules in situations where mass production of assets occurs on a repetitive and routine basis, with a typically high "turnover" rate for the produced assets. Therefore, the method is not appropriate for use in accounting for casual or occasional production of property.

You cannot use this method for property acquired for resale or property produced under a long-term contract. If a single trade or business consists of operations that include both the production of property and the acquisition of property for resale, the simplified production method must be applied to all operations of the particular trade or business.

A change to or from the simplified production method is a change in accounting method that requires consent from the IRS. For more information on the simplified production method, see section 1.263A–1T(b)(5) of the Income Tax Regulations.

Simplified service cost method. A simplified method is also available for figuring the amount of certain indirect costs that producers must allocate to inventory production. The simplified service

cost method provides for allocating administrative, support, and service costs that directly benefit or are incurred because of the performance of production activities, but also benefit other activities of the producer ("mixed service costs").

The labor-based simplified service cost method also provides for determining inventoriable mixed service costs. For more information, see Notice 88–86 (1988–2 C.B. 401).

If you are a producer, you can use the simplified service cost method whether or not you use the simplified production method. Therefore, you may determine your inventoriable mixed service costs under the simplified service cost method, and then allocate these costs to your production activities under the general provisions of the uniform capitalization rules. However, if you use the simplified production method, then the inventoriable mixed service cost is allocated under that method. You may use the simplified service cost method only for the type of properties for which the simplified production method can be used.

A change to, or from, the simplified service cost method requires consent from the IRS. You must request this change separately for each business you have. For more information on the simplified service cost method, see section 1.263A–1T(b)(6) of the Income Tax Regulations.

Retailers and Wholesalers

Retailers and wholesalers (resellers) acquiring real or personal property for resale are subject to the capitalization rules in basically the same way as manufacturers and other producers. However, resellers may use one of the simplified resale methods, discussed later, for costs required to be capitalized. For details about the simplified resale methods, see section 1.263A–1T(d) of the Income Tax Regulations and Notice 88–86 (1988–2 C.B. 401) and Notice 89–67 (1989–2 C.B. 723).

The allocation rules that apply to production activities apply to those resellers that acquire property for resale and do not use the simplified resale method. Thus, resellers who do not use the simplified resale method must allocate the additional costs required by the capitalization rules with the same degree of specificity as was required of manufacturers of inventory under prior law. In addition, these resellers can not use the various allocation methods or expedited procedures under the simplified resale method, but must use the methods and procedures allowed for the production of property under the general uniform capitalization rules including the same categories of costs.

Property acquired for resale includes the type of properties for which the simplified production method, discussed earlier, can be used. In addition, property acquired for resale may be real property or personal property (tangible or intangible). Thus, property held for sale may include:

1) Literary, musical, or artistic compositions; stocks, certificates, notes, bonds, debentures, or other evidence of indebtedness,
2) An interest in, or right to subscribe to or purchase any of the above items, and
3) Other intangible property.

$10 million gross receipts exception. The uniform capitalization rules for personal property acquired for resale do not apply if the reseller's average annual gross receipts for the three preceding tax years are $10,000,000 or less. The $10,000,000 test is not available for real property acquired for resale. For information on how to determine the amount of gross receipts, see section 1.263A–1T(d)(2) of the Income Tax Regulations.

Costs required to be capitalized. The costs required to be capitalized for property acquired for resale include the following categories of costs, whether or not the simplified resale method is elected.

1) Off-site storage or warehousing ("storage") costs, such as rent or depreciation, insurance premiums, and taxes that can be attributed to a warehouse and wages of warehouse personnel. For retailers, only the costs incurred at storage sites away from the retail sales facility must be included in inventory. The costs of storing goods at the retail sales facility do not have to be included in inventory.
2) Purchasing costs, such as the wages or salaries of employees responsible for purchasing.
3) Handling, processing, assembling, and repackaging ("handling") costs incurred in processing goods while in the reseller's possession.
4) General and administrative costs (mixed service costs) allocable to the above functions.

Simplified resale methods. Resellers may elect a simplified resale method to allocate costs to property acquired for resale. These methods include the alternative simplified resale method, the modified resale method or the simplified resale service cost method, and/or the simplified method as revised by Notice 88–86 (III)(A)(1) (1988–2 C.B. 401).

These methods must be applied separately to each trade or business of the reseller. In addition, these methods can only be used by a trade or business that is exclusively a resale operation. They are not available to a trade or business that performs any kind of production activity (unless the production is a minimal amount). These methods can be used if the property acquired for resale is produced under contract for the reseller.

Under these methods, costs required to be allocated to property acquired for resale generally include the costs incurred in purchasing, handling, and storage of such property. In addition, such costs include the general and administrative costs that can be allocated to these functions. Regulations for Internal Revenue Code section 263A provide guidelines for figuring the costs incurred that relate to these activities and the methods by which such costs allocated to the property acquired are held. Examples also apply the simplified resale method to inventories in cases involving the use of both the last-in first-out (LIFO) method and the first-in first-out (FIFO) method.

A change to or from the simplified resale method is a change in accounting method that requires consent from the IRS.

Retail method. Resellers who use the retail method of pricing inventories may figure their tax on that basis.

To use this method on your income tax return you must:

1) State that you are using the method on the return,
2) Keep accurate accounts, and
3) Use this method from year to year unless the IRS allows you to change to another method.

You must keep records for each separate department or class of goods carrying different percentages of gross profit. Purchase records should show the firm name, date of invoice, invoice cost, and your retail selling price. You should also keep records of the respective departmental or class accumulation of all purchases, markdowns, sales, stock, etc.

Capitalizing costs. Resellers are subject to the uniform capitalization rules unless they meet the $10,000,000 exception, discussed earlier. Resellers may continue to use the retail method in figuring the cost of their inventories; however, the value of opening inventories, purchases, etc., must be figured using the capitalization rules.

Closing inventory cost. Under the retail method, the total of the retail selling prices of goods on hand at the end of the tax year in each department or class of goods is reduced to approximate cost using the average markup expressed as a percentage of the total retail selling prices.

To figure the average markup percentage, do the following:

1) Add the total of the retail selling prices of the goods in the opening inventory and the retail selling prices of the goods you bought during the year (adjusted for all markups and markdowns), then
2) Subtract from that total, the cost of goods included in the opening inventory plus the cost of goods you bought during the year, and, then
3) Divide the balance by the total selling price (item 1).

You can figure approximate cost in two steps. First, find the markup in the items in the closing inventory by multiplying the total retail selling prices by the average markup percentage. Then, subtract the markup from the total retail selling prices. The result is the approximate cost.

If you have been figuring your inventory under the retail method except that, to approximate the lower of cost or market, you have followed the consistent practice of adjusting the retail selling prices of goods for markups but not markdowns, you can continue that practice provided the adjustments are bona fide and uniform and markups made to cancel or correct markdowns are also excluded. The markups included must be reduced by markdowns made to cancel or correct the markups.

If you previously figured inventories without eliminating markdowns in making adjustments to retail selling prices, you may use this practice, provided you first get permission to do so from the IRS. In the first tax return you file for your business, you can use this practice subject to approval by the IRS on examination of your tax return.

If you use LIFO with the retail method, you must adjust your retail selling prices for markdowns as well as markups.

Example. Your records show the following information on the last day of your tax year:

Item	Cost	Retail Value
Opening inventory	$52,000	$80,000
Purchases during year	53,000	78,500
Sales		98,000
Markups		2,000
Markdowns		500

Using the retail method you can figure your closing inventory from this information as follows:

Item	Cost	Markups/ Markdowns	Retail Value
Opening inventory	$ 52,000		$ 80,000
Plus: Purchases during year	53,000		78,500
Markups		$ 2,000	
Markdowns		(500)	1,500
Totals (markup percentage 25%)	$105,000		$140,000
Minus: Sales			98,000
Closing inventory at retail			$ 42,000
Minus: Markup percentage (25%)			10,500
Closing inventory at cost			$ 31,500

Markup percentage. In the preceding example, the markup ($35,000) is equal to the difference between cost ($105,000), which includes inventory at the beginning of the period, and purchases at cost plus transportation, and the retail value ($140,000), which included the inventory at sales prices and purchases at sales prices. The total markup divided by the total retail

value will give you the percentage (25%) of purchase markup. Do not use arbitrary standard percentages of purchase markup. The percentage must be the markup percentage figured as accurately as possible from your department records for the period for which you file your return.

Markdowns. Markdowns not based on actual reduction of retail sales prices (such as markdowns based on depreciation and obsolescence) are not allowed in figuring retail selling prices of the goods on hand at the end of the tax year. Markdowns are recognized only if you offered the goods to the public at the reduced prices, or if you provide proof of market changes that have forced a reduction in retail prices.

Used with other methods. The retail method may be used with the FIFO and specific identification methods. Subject to special rules, the retail method also may be used in conjunction with the LIFO method.

Failure To Comply With Rules

The uniform capitalization rules apply to costs incurred for:

1) The production or acquisition of inventory property for tax years beginning after December 31, 1986, and
2) The production of non-inventory property after December 31, 1986.

If you fail to comply with the uniform capitalization rules after these dates, you must follow special procedures to correctly comply with the rules. These procedures are explained in Notice 88–78 (1988–2 C.B. 394).

Change in Accounting Method

When you file your first return, you can, without consent from the IRS, choose any appropriate accounting method. The method you choose must be used consistently from year to year and clearly show your income.

After your first return is filed, if you want to change your accounting method, you must first get consent from the IRS. This is necessary to notify the IRS that a change is being made and to prevent you from gaining an unlawful tax advantage. The IRS will consider the need for consistency in the accounting area against your reason for wanting to change your accounting method when the method from which you are changing clearly shows your income.

The absence of IRS consent to a change in the method of accounting because you did not request a change (such as a change from an improper method of accounting to a proper method of accounting) does not prevent the IRS from imposing any penalty or addition to tax, nor diminish the amount of the penalty or the addition to tax.

A change in your accounting method includes a change not only in your overall system of accounting but also in the treatment of any material item. Although an accounting method may exist without having a pattern of treating an item the same way all the time, in most cases, an accounting method is not established for an item unless the item is treated the same way every time.

Some examples of changes that ***require*** consent are:

1) A change from the cash method to the accrual method or vice versa (unless you must change to the accrual method and you make the change automatically),
2) A change in the method or basis used to value inventories, and
3) A change in the method of figuring depreciation (except certain changes to the straight-line method, as explained in Publication 534).

Some changes that are not changes in accounting methods and ***do not require*** consent are:

1) A correction of mathematical or posting errors,
2) An adjustment of any item of income or deduction that does not involve the proper time for including it in income or deducting it, and
3) An adjustment in the useful life of a depreciable asset.

Unless you apply only for a change under the *Automatic Change to Accrual Method*, discussed later, do not change your method of accounting for tax purposes until the IRS has approved your request.

Consent To Change

If you are not making a change under Revenue Procedure 74–11 (discussed later), you must file a current Form 3115, *Application for Change in Accounting Method*, and attach the fee of $500. You generally must file the application within the first 180 days of the tax year for which you are requesting the change. If the 180th day falls on a Saturday, Sunday, or legal holiday, the filing date is extended to the next working day. Thus, a calendar year taxpayer wanting to change accounting methods for 1991 must file by June 29, 1991.

Unless otherwise specifically provided, IRS consent to change for a particular year will be set forth in a ruling letter from the National Office. If you agree to the terms and conditions contained in the letter, you must sign and date the agreement copy of the ruling letter in the space provided (Consent Agreement) and return it to the National Office within 45 days.

An application on Form 3115, filed after the 180-day period but within 9 months after the beginning of the tax year for which the change is requested, can be treated as filed on time if you show reasonable cause for filing it late. See *Extensions of time to file application*, later.

If you file your application on Form 3115 after the 180-day period and the IRS does not grant you an extension of time to secure consent, you can treat your application as a timely application for the next tax year. To make this choice, you must notify the IRS of your intention within 30 days after being denied the extension by filing a current Form 3115 for the subsequent tax year. To have your application qualify as a timely application for the next tax year, you must also meet the requirements described under *Early applications*, below.

Extension of time to file application. If you have good reason for filing late, the IRS may grant you an extension. The following factors generally will be considered in determining whether or not you have shown good cause:

1) Due diligence—What action did you take to determine the existence of and the requirements for the application, and what efforts did you make to comply with them?
2) Prompt action—Are you requesting the extension within a reasonable time after discovering a missed deadline or a deadline that could not be kept?
3) Intent—Did you intend to make the election or application on time, and what were the circumstances that made you unable to do so?
4) Interests of the government—Does granting the extension neither prejudice the interests of the government nor cause undue administrative burden?
5) Consistency with the law and regulations—Does granting the extension achieve a consistency with the objectives of the law and the regulations?

However, if you file your request later than 9 months after the beginning of your tax year, the reasons must be unusual and compelling.

See Revenue Procedure 79–63 (1979–2 C.B. 578), for additional information on the extension of time to file your application.

Early applications. You can file an application for a change in accounting method within a 6-month period before the beginning of the year you want the change to take effect. These applications are known as "early applications." For an early application to qualify, the following requirements must be met:

1) The application must be on a current Form 3115 and it must be complete in all respects, except for the amount of the adjustment under section 481(a) for the year of change.
2) You must then furnish the adjustment under section 481(a) (referred to in item (1) above) within the first 90 days after the beginning of the year of change.
3) The user fee of $500 must be attached to Form 3115.

If you have not furnished all information, including the amount of the adjustment under section 481(a), within the first 90 days after the beginning of the year of change, the IRS will notify you. Then you have 120 days after the beginning of the year of change to complete your application or your case will be closed and the IRS will not process your Form 3115. In order to assist in the processing of these early applications, put "FILED UNDER SEC 5.03(1) of REV. PROC. 84–74" at the top of your Form 3115.

If your early application is not perfected within 120 days, or if your Consent Agreement, discussed earlier, is not signed and returned to the IRS, and you file another early application for a later tax year requesting the same accounting method change requested in the first application, you must attach a copy of the first Form 3115 you filed and any related correspondence. Also, you must attach an explanation as to why the application was not perfected or why the change was not made.

Conferences. At the time you file your Form 3115, you should indicate whether or not you request a conference if the IRS considers an unfavorable response to your request. If you do not request a conference, the IRS presumes that you do not want one.

If you specifically request a conference, the National Office will arrange one before the IRS formally replies to your Form 3115.

Two or more businesses. If you operate two or more separate and distinct trades or businesses, you can use a different accounting method for each, provided the method used clearly reflects the income of each trade or business. A business is separate and distinct if books and records are maintained for each trade or business.

However, when the use of different methods of accounting results in the creation or shifting of profits or losses (for example, through inventory adjustments, sales, purchases, or expenses) and there is not a clear reflection of income, your businesses will not be considered separate and distinct. If you request a change in accounting method for any of these businesses, your request will not be processed and the IRS will return your Form 3115 unless the proposed change in method corrects the defect, resulting in a clear reflection of income. In addition to filing a completed current Form 3115, you must also identify all of your other trades or businesses by name and employer identification number and the method of accounting used by each.

Incomplete Form 3115. If the IRS receives your application and it is not properly completed according to the instructions for a current Form

3115, you will be notified and given 45 days from the date of the notification letter to furnish the necessary information. The IRS will not process an incomplete application. However, the IRS may grant an additional 15 days to furnish the information in very unusual and compelling circumstances. Your written request for the 15-day extension must be submitted within the 45-day period.

Examination of return. If you have been contacted by the IRS to schedule an examination of your return, you may, under Revenue Procedure 84–74 (1984–2 C.B. 736), obtain consent to change your accounting method, provided the proposed method is a permitted one. If the method being changed involves an issue raised by the IRS during the examination, the year of change is generally the most recent tax year being examined. However, the year may not be later than the most recent tax year for which a return has been filed as of the date the examination began.

Your request for application of Revenue Procedure 89–74 should be made in a letter to the Commissioner of Internal Revenue, Attention: CC:IT&A. This request should be sent to the District Director of the District in which the return is being examined. The Director will forward it with comments to the National Office. You should send a completed current Form 3115 with the letter and identify it by putting "FILED UNDER SECTION 5.12(1)(a) of REV. PROC. 84–74" at the top of the form. Pending action by the National Office, the District Director will suspend action on the particular issue.

Revenue Procedure 84–74 does not apply to certain cases. For example, it does not apply to cases under examination by the IRS in which the year or years under examination encompass the tax year in which you started the practice or method that is at issue.

Simplified Procedures

Simplified procedures exist under which certain taxpayers may presume to have IRS consent to change their overall method of accounting from the cash to the accrual method. See Revenue Procedure 85–37 (1985–2 C.B. 438). This procedure applies to taxpayers who use the cash method as their overall method and who want to change their overall method to the accrual method. The procedure does not apply to taxpayers who must discontinue use of the cash method and who want to use the accrual method, discussed later under *Automatic Change to Accrual Method*.

Revenue Procedure 85–37 specifically excludes from its application certain categories of taxpayers. These include:

1) Financial institutions,
2) Farmers,
3) Cooperatives,
4) Individuals other than sole proprietors,
5) Taxpayers wanting to change to the overall accrual method of accounting, and to a special method such as the long-term contract method of accounting,
6) Taxpayers required to use an inventory method of accounting to clearly determine income, and
7) Taxpayers under examination or who have been contacted by the IRS.

The procedure also excludes other taxpayers under certain circumstances. For example, even if you are in a category other than one specifically excluded, the procedure would not apply to you if you are required to use an inventory method of accounting to clearly determine income. In that case, however, you may be able to use another simplified procedure to change your overall method of accounting from the cash to the accrual method. See Revenue Procedure 85–36 (1985–2 C.B. 434).

If you want to make this change from the cash to the accrual method and you meet the requirements to do so, file a copy of Form 3115 with the National Office of IRS no later than 270 days after the beginning of the year of change. The original should be attached to your return for the year of change. See section 6 of Revenue Procedures 85–36 and 85–37.

Another simplified procedure is available in which you may presume to have IRS consent to change your ***method of figuring depreciation*** to another specified method. See Revenue Procedure 74–11 (1974–1 C.B. 420). To change depreciation methods, file Form 3115, within the first 180 days of the year of change, with the Director of the Internal Revenue Service Center where the return will be filed.

Automatic Change to Accrual Method

If you are required to change from the cash method to the accrual method, discussed earlier under *Limits on Use of Cash Method*, you are not required to have prior approval from the IRS to make this change. However, if you do not make this change by the due date (including extensions) of the income tax return for the first tax year affected, you must get prior approval from the IRS to make this change. In certain cases, you can make this change on an amended return (see section 1.448–1T(j) of the Income Tax Regulations).

Any adjustment required by section 481(a) of the Internal Revenue Code must be included in income over the lesser of:

1) The number of tax years you used the cash method, or
2) 4 tax years.

If you go out of business before the end of the section 481(a) adjustment period, you must take into account, in the year you end your business, the balance of the section 481(a) adjustment not previously taken into account in computing taxable income.

Form 3115. Even though this change to the overall accrual method is regarded as automatic, you must complete and file Form 3115 no later than the due date (including extensions) for filing your income tax return. Attach Form 3115 to your income tax return. In addition, you must attach a statement to your income tax return indicating the period over which the section 481(a) adjustment is to be taken into account and your basis for making such conclusion. At the top of Form 3115, you should have the statement, "AUTOMATIC CHANGE TO ACCRUAL METHOD—SECTION 448."

If you wish to use a special method such as a long-term contract method, in addition to the overall accrual method, you must follow the requirements discussed above under *Consent To Change* for obtaining IRS consent to use the special method. You must put at the top of Form 3115: "CHANGE TO A SPECIAL METHOD OF ACCOUNTING—SECTION 448."

If your application for change in method is approved, use the automatic procedure, discussed above, when filing your income tax return, and for determining the timing of your section 481(a) adjustment. However, if approval is not granted or your Form 3115 is not timely filed, you must change to an overall accrual method of accounting. For more information, see section 1.448–1T(h) of the Income Tax Regulations.

Inventories

If the uniform capitalization rules require that you change your accounting method, the change is made by revaluing the items or costs included in your beginning inventory for the year of change as if the capitalization rules had been in effect in all prior periods. In revaluing inventory costs, the capitalization rules apply to all inventory costs accumulated in prior periods. The difference between the inventory as originally valued and the inventory as revalued is equal to the amount of the adjustment required under section 481(a) of the Internal Revenue Code.

If you are required to make this change, and do so timely, you do not need prior approval from the IRS. The adjustment arising from the change in method is taken into account over a period not to exceed 4 years. The timing of the section 481(a) adjustment is made according to the regulations for section 263A of the Internal Revenue Code, except that the maximum number of years over which the adjustment is to be spread is the number of tax years (not to exceed 4) that the taxpayer has engaged in the particular trade or business of producing property or acquiring property for resale to which the adjustment applies. The adjustment is generally taken into account using the procedures outlined in Revenue Procedure 84–74, discussed earlier under *Early applications*.

To determine estimated tax payments, the section 481(a) adjustment is recognized ratably throughout the tax year of the adjustment. Any net operating loss and tax credit carryforwards are allowed to offset any positive net section 481(a) adjustment.

Generally, in revaluing the costs of inventory, you must determine, based on all the facts and circumstances, the direct and indirect costs that are assigned to each item of inventory under the capitalization rules (the "facts and circumstances revaluation"). The revaluation is required for every prior period that is relevant in determining the total restated balance as of the year of change.

Under the facts and circumstances revaluation, you must generally apply the capitalization rules to your production and resale activities, with the same degree of specificity as required of inventory manufacturers. You can, however, use reasonable estimates and procedures in valuing inventory costs if:

1) You lack (and are not able to reconstruct from your books and records) actual financial and accounting data required to apply the capitalization rules to the relevant facts and circumstances surrounding a particular item of inventory, or cost, and
2) The total amount of costs, for which reasonable estimates and procedures are used, is not significant in comparison to the total restated value (including costs previously capitalized) or costs.

If you cannot comply with requirement (2) above because the amount of costs that would require the use of estimates and procedures is significant, you must revalue your inventories as prescribed in the regulations under section 263A of the Internal Revenue Code.

Automatic change for capitalization rules. If you are required to change your method of accounting under the capitalization rules, you may be able to automatically change such method. A change is required under the capitalization rules if the change is necessary for you to properly allocate and capitalize costs for production and resale activities. An automatic change in method of accounting under the uniform capitalization rules includes:

1) A change in method of accounting in which you properly expense certain costs under the capitalization rules that you previously capitalized under your prior method of accounting, and
2) A change in method of accounting in which you properly capitalize certain costs under the capitalization rules that you previously expensed under your prior method of accounting, regardless of whether such prior

methods of accounting were correct or erroneous methods under the law in effect at that time.

A change is required if it relates to factors other than those described above. A change in method of accounting is considered all methods of complying with the provisions of section 263A of the Internal Revenue Code including simplified methods, formulas, allocation methods, and inventory value procedures.

If you are required to change your method of accounting as discussed above, and you do not make the change, you are considered to be using an improper method of accounting.

INDEX

Accounting methods:
- Accrual method.....7
- Automatic change to accrual.....15
- Cash method.....6
- Change in.....14
- Methods you may use.....6
- Simplified procedures to change.....15

Accounting periods:
- 52–53 week tax year.....1
- Business purpose tax year.....4
- Calendar tax year.....1
- Change in.....2
- Corporations.....5
- Employment tax.....6
- Excise tax.....6
- Fiscal tax year.....1
- Husband and wife.....2
- Improper tax year.....3
- Partnerships.....3
- Personal service corporations.....3
- S corporations.....3
- Section 444 election.....4
- Short tax year.....2

Accrual accounting method.....7
Accrual method:
- Expenses.....8
- Income.....7

Advance income for services.....7
Advance income from sales.....7
Business purpose tax year.....4
Calendar tax year.....1
Capitalization rules:
- Allocation methods.....12
- Costs not capitalized.....12
- Direct costs.....11
- Exceptions.....11
- Indirect costs.....12
- Retailers and wholesalers.....13
- Retail method.....13
- Simplified production method.....12
- Simplified resale methods.....13
- Simplified service cost method.....12

Cash accounting method.....6
Constructive receipt of income.....6
Contested liabilities.....9
Corporation tax periods.....5
Cost identification.....10
Death of individual.....2
Economic performance rule.....8
Employment tax periods.....6
Excise tax periods.....6
Fiscal tax year.....1
Inventories:
- Change in accounting method.....15
- Cost identification.....10
- FIFO and LIFO.....10
- Lower of cost or market.....10
- Perpetual or book.....11
- Specific identification.....10
- Valuing.....10

Limits on use of cash method.....6
Partnerships.....3
Personal service corporations.....3, 7
Related persons.....9
Retailers and wholesalers.....13
S corporations.....3
Section 444 election.....4
Short tax year.....2
Simplified resale methods.....13
Simplified service cost method.....12
Uniform capitalization rules (see *Capitalization rules*).....11
User fees.....3

*U.S. Government Printing Office: 1990 — 282-015/20015

pages tightly bound